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[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-118425-18]

RIN 1545-B090

Section 199A Rules for Cooperatives and their Patrons

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; withdrawal of notice of proposed rulemaking.

SUMMARY: These proposed regulations provide guidance to cooperatives to which sections 1381 through 1388 of the Internal Revenue Code (Code) apply (Cooperatives) and their patrons regarding the deduction for qualified business income (QBI) under section 199A(a) of the Code as well as guidance to specified agricultural or horticultural cooperatives (Specified Cooperatives) and their patrons regarding the deduction for domestic production activities under section 199A(g) of the Code. These proposed regulations also provide guidance on section 199A(b)(7), the rule requiring patrons of Specified Cooperatives to reduce their deduction for QBI under section 199A(a). In addition, these proposed regulations include a single definition of <u>patronage and nonpatronage</u> under section 1388 of the Code. Finally, these proposed regulations propose to remove the final regulations, and withdraw the proposed regulations that have not been finalized, under former section 199. These proposed regulations affect

Cooperatives as well as patrons that are individuals, partnerships, S corporations, trusts, and estates engaged in domestic trades or businesses.

DATES: Written (including electronic) comments and requests for a public hearing must be received by [**INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**]. As of [**INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER**], the proposed rule published on August 27, 2015 (80 FR 51978), is withdrawn.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-118425-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to: CC:PA:LPD:PR (REG-118425-18), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-1118425-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., 20224.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, James Holmes at (202) 317-4137; concerning submissions of comments and requests for hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 199A and 1388 of the Code.

Section 199A was enacted on December 22, 2017, by section 11011 of "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-97, 131 Stat. 2054, 2063 (TCJA). Parts of section 199A were amended on March 23, 2018, as if included in TCJA, by section 101 of Division T of the Consolidated Appropriations Act, 2018, Public Law 115-141, 132 Stat. 348, 1151 (2018 Act). Section 199A applies to taxable years beginning after 2017 and before 2026. Unless otherwise indicated, all references to section 199A are to section 199A as amended by the 2018 Act.

In addition, section 13305 of the TCJA repealed section 199 (former section 199), which provided a deduction for income attributable to domestic production activities (section 199 deduction). Public Law 115-97, 131 Stat. 2054, 2126. The repeal of former section 199 is effective for all taxable years beginning after 2017. This notice of proposed rulemaking therefore proposes to remove the final regulations under former section 199, and withdraws proposed regulations under former section 199.

Section 199A(a) provides taxpayers a deduction of up to 20 percent of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, and up to 20 percent of qualified real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income (section 199A(a) deduction). Section 199A(b)(7) requires patrons of Specified Cooperatives to reduce their section 199A(a) deduction if those patrons receive certain payments from such cooperatives. Section 199A(g) provides a deduction for Specified Cooperatives and their patrons (section 199A(g) deduction) that is based on the former section 199 deduction. Before the amendments of the 2018 Act, section 199A(g) provided a modified version of the section 199A(a) deduction for Specified Cooperatives.

The Treasury Department and the IRS published proposed regulations (REG-107892-18) providing guidance on the section 199A(a) deduction in the *Federal Register* (83 FR 40884) on August 16, 2018 (August 2018 NPRM). The final regulations were published in the *Federal Register* (84 FR 2952) on February 8, 2019 (TD 9847).

TD 9847 did not address patrons' treatment of payments received from Cooperatives for purposes of section 199A(a) or the section 199A(g) deduction for Specified Cooperatives, though it did restate the reduction required under section 199A(b)(7). See §1.199A-1(e)(7). The August 2018 NPRM preamble stated that the Treasury Department and the IRS would continue to study the area and intended to issue separate proposed regulations describing rules for applying section 199A to Specified Cooperatives and their patrons. This notice of proposed rulemaking sets forth those proposed regulations and provides additional guidance to patrons calculating their 199A(a) deduction.

Explanation of Provisions

The purpose of these proposed regulations is to provide guidance regarding the application of sections 199A(a), 199A(b)(7), and 199A(g) to Cooperatives and their patrons as well as to Specified Cooperatives and their patrons. Whereas section 199A(a) is generally available to patrons of all Cooperatives, sections 199A(b)(7) and 199A(g) apply only to Specified Cooperatives and their patrons.

These proposed regulations are organized into six sections: proposed §§1.199A-7 through 1.199A-12. Proposed §1.199A-7 describes rules for patrons of Cooperatives to calculate their section 199A(a) deduction and rules for patrons of Specified Cooperatives to calculate the reduction to their section 199A(a) deduction as required by section 199A(b)(7). Unless otherwise provided in these proposed regulations, all of the rules set forth in TD 9847 relating to the section 199A(a) deduction apply to Cooperatives and their patrons. Specified Cooperatives are a subset of Cooperatives; therefore, the requirements of proposed §1.199A-7 also apply to Specified Cooperatives.

Proposed §1.199A-8 sets out the criteria that Specified Cooperatives must satisfy to qualify for the section 199A(g) deduction, and sets forth four steps necessary to calculate this deduction. These proposed regulations provide that the section 199A(g) deduction available to Specified Cooperatives and their patrons is generally computed only with respect to patronage gross receipts and related deductions. Exempt Specified Cooperatives (those that qualify under section 521) may compute their section 199A(g) deductions with respect to both patronage and nonpatronage gross receipts and related deductions.

Proposed §§1.199A-9 through 1.199A-11 provide additional guidance, based on the regulations under former section 199, regarding the four steps set forth in proposed §1.199A-8. Proposed §1.199A-9 provides additional rules for determining a Specified Cooperative's domestic production gross receipts (DPGR). Proposed §1.199A-10 provides additional rules for calculating costs (including cost of goods sold (COGS) and other expenses, losses, and deductions) allocable to a Specified Cooperative's DPGR. Proposed §1.199A-11 provides additional rules for determining the W-2 wage limitation in section 199A(g)(1)(B). Proposed §1.199A-12 details rules for applying section 199A(g) in the context of an expanded affiliated group (EAG) and other special rules contained in section 199A(g)(5) that are not otherwise addressed in these proposed regulations.

These proposed regulations also include, under section 1388, a single definition of <u>patronage and nonpatronage</u> in proposed §1.1388-1(f), which is intended to reflect the current case law under section 1388. This Explanation of Provisions describes each section of the proposed regulations in more detail.

I. <u>Proposed §1.199A-7, Rules for Patrons of Cooperatives</u>

A. <u>In General</u>

As noted in the Background, section 199A(a) may allow a taxpayer a deduction of up to 20 percent of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, and up to 20 percent of qualified REIT dividends and PTP income. A section 199A(a) deduction is not available for wage income or for business income earned through a C corporation.

C corporations are not eligible for the section 199A(a) deduction. Cooperatives are C corporations for Federal income tax purposes and, therefore, are not eligible for the section 199A(a) deduction. Similarly, patrons that are C corporations are also not eligible for the section 199A(a) deduction. However, patrons that are individuals are eligible for the section 199A(a) deduction. Section 1.199A-1(a)(2) provides that, for purposes of applying the rules of §§1.199A-1 through 1.199A-6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the section 199A(a) deduction is determined by the trust or estate under the rules of §1.199A-6. These proposed regulations apply this same usage of the term individual.

The benefits of section 199A(a) are limited to individuals with income from a trade or business as defined in section 199A(d)(1) and §1.199A-1(b)(14) (trade or business) with QBI. To the extent a patron operating a trade or business has income directly from that business (as opposed to receiving a patronage dividend from a Cooperative), the patron must follow the rules of §§1.199A-1 through 1.199A-6 to calculate the section 199A deduction. However, to the extent a patron receives patronage dividends or similar payments from a Cooperative, the patron must follow the additional special rules and clarification in proposed §1.199A-7 to calculate the section 199A deduction.

For these purposes, patronage dividends or similar payments include money, property, qualified written notices of allocations, and qualified per-unit retain certificates for which an exempt or nonexempt Cooperative receives a deduction under section 1382(b), and nonpatronage distributions paid in money, property, qualified written notices of allocation as well as money or property paid in redemption of a nonqualified written notice of allocation for which an exempt Cooperative receives a deduction under section 1382(c)(2) (hereinafter collectively referred to as patronage dividends or similar payments).

Section 1.199A-7(c) and (d) of these proposed regulations provide that these patronage dividends or similar payments may be included in the patron's QBI: (i) To the extent that these payments are related to the patron's trade or business, (ii) are qualified items of income, gain, deduction, or loss at the Cooperative's trade or business level, (iii) are not income from a specified service trade or business (SSTB), as defined in section 199A(d)(2), at the Cooperative's trade or business level (except as permitted by the threshold rules, see §1.199A-5(a)(2)), and (iv) provided the patron receives certain information from the Cooperative about these payments (see proposed §1.199A-7(c)(3) and (d)(3)). Proposed §1.199A-7(e) provides that in situations in which a patron conducts a trade or business that receives patronage dividends or similar payments from a Cooperative, the W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property considered are those of the patron's trade or business and not of the Cooperative that directly conducts the trade or business from which the payments arise. All of these proposed rules are discussed further in this section.

B. QBI of Patrons

Although Cooperatives are C corporations for Federal income tax purposes, section 1382(b) and (c) allow Cooperatives to determine taxable income after deducting distributions of patronage dividends or similar payments to patrons. The effect of these deductions is to remove the distributions from income taxed at the Cooperative level leaving it subject to income tax only at the patron level. Exempt and nonexempt Cooperatives are both permitted to deduct patronage distributions if they satisfy the requirements described in section 1382(b). Only exempt Cooperatives are permitted to also deduct nonpatronage distributions if the requirements under section 1382(c) are met. Cooperatives are subject to Federal income tax on income for which no deduction may be taken under section 1382(b) or (c), in the same manner as any C corporation.

Section 1.199A-3(b) contains the general rules regarding QBI. QBI is the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under those rules. While income from the ownership of a C corporation is generally not QBI, section 199A provides a special rule for patrons receiving patronage dividends from a Cooperative.

Section 199A(c)(3)(B)(ii) provides that any amount described in section 1385(a)(1), which concerns patronage dividends, is not treated as an exclusion to a patron's QBI. The Joint Committee on Taxation Report (JCX-6-18, released March 22, 2018) (Joint Committee Report) states that QBI includes any patronage dividend (as defined in section 1388(a)), per-unit retain allocation (as defined in section 1388(f)), qualified written notice of allocation (as defined in section 1388(c)), or any other similar amount received from a Cooperative, provided such amount is otherwise a qualified item of income, gain, deduction, or loss (that is, such amount is (i) effectively connected with the conduct of a trade or business within the United States, and (ii) included or allowed in determining taxable income for the taxable year). Joint Committee Report, pages 24-25. As a result, the rules of proposed §1.199A-7(c) provide that patronage dividends or similar payments (as previously discussed) are included in calculating QBI for purposes of the patrons' section 199A(a) deduction provided the amounts are otherwise qualified items. To be otherwise qualified, these amounts must be qualified items of income, gain, deduction, and loss under section 199A(c)(3).

Unlike nonexempt Cooperatives, exempt Cooperatives are permitted to deduct nonpatronage distributions under section 1382(c). As a result, this income is subject to taxation only at the patron level. The rules of proposed §1.199A-7(c) provide that a patron's QBI can include payments to patrons for which the exempt Cooperative receives a deduction under section 1382(c)(2) in addition to payments for which the exempt Cooperative receives a deduction under section 1382(b). That is, amounts paid under section 1382(c)(2) are treated by a patron as equivalent to patronage dividends under section 1382(b) for purposes of QBI. Amounts paid under section 1382(c)(1) (dividends on capital stock), however, are dividends from ownership of C corporations, which are not included in QBI.

TD 9847 generally provides that income is tested at the trade or business level where it is directly generated. Accordingly, these proposed regulations provide that patronage dividends or similar payments are considered to be generated from the trade or business the Cooperative conducts on behalf of or with the patron, and are tested by the Cooperative at its trade or business level.

A patron must determine QBI for each trade or business it directly conducts. However, in situations where the patron receives a distribution from a Cooperative that is a patronage dividend or similar payment, the Cooperative determines whether that distribution contains qualified items of income, as defined under section §1.199A-3(b) , and reports that information to the patron. The patron needs this information to determine its section 199A(a) deduction, and the Cooperative directly conducting the trade or business from which the distribution is derived is in the best position to know whether the patronage dividend or similar payment contains qualified items. The

Cooperative must report this information regardless of whether the patron's taxable income does not exceed the threshold amount ($315,000 in the case of joint returns and $157,500 for all other taxpayers for any taxable year beginning before 2019). For taxable years beginning after 2018, see Rev. Proc. 2018-57, 2018-49 IRB 827, or its successor (relating to inflation adjustments).

A patron must use that information when determining the patron's section 199A(a) deduction. For example, if the Cooperative determines an entire distribution does not contain any qualified item of income, gain, deduction, and loss because it is not effectively connected with the conduct of the Cooperative's trade or business within the United States, the Cooperative does not include such amount when reporting qualified items to the patron, and the patron does not include the distribution in the patron's QBI. In addition, to the extent the distribution includes interest income that is not properly allocable to the Cooperative's trade or business on behalf of, or with, its patrons, the distribution is not a qualified item of income, gain, deduction, and loss. As a result, the Cooperative does not include such amount when reporting qualified items to the patron, and the patron does not include the income in the patron's QBI.

Proposed §1.199A-7(c)(3) provides that the Cooperative must report the amount of qualified items of income, gain, deduction, or loss in the distributions made to the patron on an attachment to or on the Form 1099-PATR, Taxable Distributions Received From Cooperatives (Form 1099-PATR) (or any successor form), issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. The Cooperative does not include any items from an SSTB in reporting the amount of qualified items of income, gain, deduction, and loss and must instead follow the rules in proposed §1.199A-7(d) for income from an SSTB. If a patron does not receive such information from the Cooperative on or before the due date of the Form 1099-PATR, the amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero. This presumption does not apply to amounts of qualified items of income, gain, deduction and loss to the extent that they were not reported on the Form 1099-PATR or attachment thereto before the publication of these proposed regulations in the *Federal Register*. These rules apply to both exempt and nonexempt Cooperatives as well as patronage and nonpatronage distributions. The Treasury Department and the IRS request comments on these reporting requirements and whether any additional information from Cooperatives that make distributions to their patrons is needed for their patrons to determine their section 199A(a) deduction.

C. <u>Specified Service Trade or Business</u>

Section 199A(c)(1) provides that only items attributable to a qualified trade or business are taken into account in determining the section 199A(a) deduction for QBI. Under section 199A(d)(1) a "qualified trade or business" excludes (A) an SSTB or (B) the trade or business of performing services as an employee. TD 9847 provides that, unless an exception applies, if a trade or business is an SSTB, none of its items are to be taken into account for purposes of determining a taxpayer's QBI.

Under section 199A(d)(3), individuals with taxable income not exceeding the threshold amount ($315,000 in the case of joint returns and $157,500 for all other taxpayers for any taxable year beginning before 2019), are not subject to a restriction with respect to SSTBs. For taxable years beginning after 2018, <u>see</u> Rev. Proc. 2018-57, 2018-49 IRB 827, or its successor. Therefore, if an individual has taxable income not exceeding the threshold amount, the individual is eligible for the section 199A(a) deduction with respect to qualified items of income, gain, deduction, and loss from the SSTB notwithstanding that the trade or business is an SSTB. The inapplicability of the SSTB rules, W-2 wage limitation, and UBIA of qualified property limitation in computing the section 199A(a) deduction is subject to a phase-in for individuals with taxable income within the phase-in range. See the rules in §1.199A-5 for the rules relating to SSTBs.

The rules in proposed §1.199A-7(d) clarify that a patron (whether the patron is a relevant passthrough entity (RPE) or an individual) must determine whether the trades or businesses it directly conducts are SSTBs. These proposed rules also provide that in the case of a patron's trade or business that receives patronage dividends or similar payments distributed from a Cooperative, the Cooperative must determine whether the distributions from the Cooperative include items of income, gain, deduction, and loss from an SSTB directly conducted by the Cooperative, and whether such items are qualified items with respect to such SSTB. The Cooperative must report to the patron the amount of qualified items of income, gain, deduction, and loss from an SSTB directly conducted by the Cooperative. The patron then determines if the distribution may be included in the patron's QBI depending on the patron's taxable income and the statutory phase-in and threshold amounts. Because the Cooperative may not know whether the patron's taxable income exceeds the threshold amount, the Cooperative must report this information to all patrons. Without this information, a patron with taxable income within the phase-in range or below the threshold amount would not have the information necessary to take into account the amount of qualified items of income, gain, deduction, and loss from an SSTB in determining the patron's section 199A(a) deduction for QBI. The rules in §1.199A-5 are applied by the Cooperative to determine if the trade or business is an SSTB. For example, the Cooperative will apply the gross receipts de minimis rules in §1.199A-5(c)(1) to determine if the trade or business is an SSTB.

Proposed §1.199A-7(d)(3) provides that the Cooperative must report to the patron the amount of SSTB income, gain, deduction, and loss in distributions that is qualified with respect to any SSTB directly conducted by the Cooperative on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report the amount on or before the due date of the Form 1099-PATR, then only the amount that a Cooperative reports as qualified items of income, gain, deduction, and loss under §1.199A-7(c)(3) may be included in the patron's QBI, and the remaining amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero. This presumption does not apply to amounts of qualified items of income, gain, deduction and loss to the extent that they were not reported on the Form 1099-PATR or attachment thereto before the publication of these proposed regulations in the *Federal Register*. These rules apply to both exempt and nonexempt Cooperatives as well as to patronage and nonpatronage distributions. The Treasury Department and the IRS request comments on these reporting requirements and whether any additional information from Cooperatives that make distributions to their patrons is needed for their patrons to determine their section 199A(a) deduction.

D. Determination of W-2 Wages and UBIA of Qualified Property

Section §1.199A-1(d) addresses the calculation of the section 199A(a) deduction for individuals with taxable income exceeding the threshold amount and provides guidance on the application of these limitations. All of the rules relating to the REIT dividends and qualified PTP income component of the section 199A(a) deduction applicable to individuals with taxable income not exceeding the threshold amount also apply to individuals with taxable income exceeding the threshold amount. The QBI component of the section 199A(a) deduction, however, is subject to limitations for individuals with taxable income exceeding the threshold amount. These include the limitations based on the W-2 wages of the trade or business or a combination of the W-2 wages and the UBIA of qualified property.

Under §1.199A-2, W-2 wages and UBIA of qualified property are determined by the individual or RPE that directly conducts the trade or business.
Section 199A(f)(1)(A)(2)(iii) requires that S corporations and partnerships allocate W-2 wages and UBIA of qualified property to their owners in accordance with each owner's applicable share, and §1.199A-6 contains additional information regarding these reporting requirements. Section 199A does not provide a similar rule for Cooperatives.

Section 199A(c)(3)(B)(ii) provides that patronage dividends or similar payments may be treated as qualified items of income. Only the Cooperative knows the origin and character of the patronage dividends or similar payments. As a result, the Cooperative must determine if these payments meet the statutory requirements in section 199A(c)(3), and must provide information to the patron for it to compute its section 199A(a) deduction. In contrast, section 199A contains special rules for W-2 wages and UBIA of qualified property. To provide that Cooperatives allocate their W-2 wages and UBIA of qualified property to their patrons would be to treat the Cooperatives as RPEs when they are C corporations. Therefore, the rules in proposed §1.199A-7(e) provide that patrons directly conducting trades or businesses that receive patronage dividends or similar payments from a Cooperative calculate the W-2 wage and UBIA of qualified property limitations at the patron level based on the patrons' trades or businesses, without any regard to the Cooperative's W-2 wages or UBIA of qualified property.

In summary, a Cooperative must report to patrons: (i) Whether the patronage dividends or similar payments include qualified items of income, gain, deduction, and loss from a non-SSTB and (ii) whether the distributions from the Cooperative include qualified items of income, gain, deduction, and loss from an SSTB directly conducted by the Cooperative, but a Cooperative does not report any W-2 wages or UBIA of qualified property to patrons. The Treasury Department and the IRS request comments on these proposed rules regarding W-2 wages and UBIA of qualified property and whether it would be appropriate for Cooperatives to be required to report such amounts to patrons to determine their section 199A(a) deduction.

E. Special Rules for Patrons of Specified Cooperatives

Section 199A provides special rules for patrons of Specified Cooperatives. Because patrons of Specified Cooperatives may be eligible to take both a section 199A(a) and section 199A(g) deduction, section 199A(b)(7) provides that if a trade or business of a patron of a Specified Cooperative receives qualified payments (as defined in section 199A(g)(2)(e) and proposed §1.199A-8(d)(2)(ii)) from such

Specified Cooperative that are included in the patron's QBI, the patron must reduce its section 199A(a) deduction by the lesser of (i) 9 percent of so much of the QBI with respect to such trade or business that is properly allocable to qualified payments from the Specified Cooperative, or (ii) 50 percent of so much of the patrons' W-2 wages (determined under section 199A(b)(4)) with respect to such trade or business as are so allocable. This reduction is required by section 199A(b)(7) whether the Specified Cooperative passes through all, some, or none of the Specified Cooperative's section 199A(g) deduction to the patron in that taxable year.

Section 1.199A-3(b)(5) provides an allocation method for items of QBI attributable to more than one trade or business. That allocation method also applies to patrons with multiple trades or businesses. The rules in proposed §1.199A-7(f)(2) provide an additional similar allocation method in situations where a patron receives qualified payments and income that is not a qualified payment in a trade or business. The patron must allocate those items using a reasonable method based on all the facts and circumstances. Different reasonable methods may be used for different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonably based on all the facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations. The Treasury Department and the IRS are open to considering whether a permissible "reasonable method" should be specified in regulations or permitted to include methods based on direct tracing, allocations based on gross income, or other methods, within appropriate parameters. The Treasury Department and the IRS request comments on possible reasonable methods for the allocation of items not clearly attributable to a single trade or business, and whether any safe harbors may be appropriate.

Because the section 199A(b)(7) reduction applies to the portion of a patron's QBI that relates to qualified payments from a Specified Cooperative, these proposed rules provide a safe harbor allocation method for patrons with taxable income not exceeding the threshold amounts set forth in section 199A(e)(2) to determine how to calculate the section 199A(b)(7) reduction. The safe harbor allocation method is intended to provide a straightforward method for patrons if their trade or business receives qualified payments from a Specified Cooperative in addition to other income. To calculate the required section 199A(b)(7) reduction, the patron must allocate the aggregate business expenses and W-2 wages between qualified payments and other gross receipts. The safe harbor allocation method allows patrons to allocate by ratably apportioning business expenses and W-2 wages based on the proportion that the amount of qualified payments bears to the total gross receipts used to determine QBI. The Treasury Department and the IRS request comments on this safe harbor rule and whether there are additional or alternative safe harbors that may be appropriate.

Further, to make the calculation required by section 199A(b)(7), the patron will need to know the qualified payments allocable to the patron that were used in calculating a Specified Cooperative's section 199A(g) deduction. In order to enable the patron to make this calculation, proposed §1.199A-7(f)(3) requires the Specified Cooperative to report the amount of such qualified payments on an attachment to or on the Form 1099-PATR, (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

F. Transition Rule

Congress provided a special transition rule relating to qualified payments under former section 199 made by Specified Cooperatives in section 101 of the 2018 Act. Under this transition rule, the repeal of former section 199 for taxable years beginning after December 31, 2017, does not apply to former section 199 qualified payments received by a patron from Specified Cooperatives in a taxable year beginning after December 31, 2017, to the extent such qualified payments are attributable to qualified production activities income (QPAI) with respect to which a deduction is allowable to the Specified Cooperatives under former section 199 for a taxable year of the Specified Cooperatives beginning before January 1, 2018. Such qualified payments remain subject to former section 199, and any deduction under former section 199 allocated by the Specified Cooperatives to their patrons related to such qualified payments may be deducted by such patrons in accordance with former section 199. In addition, no deduction is allowed under section 199A(a) and (g) with respect to such qualified payments. See Pub. L. 115–97, title I, §13305(c), Dec. 22, 2017, 131 Stat. 2054, 2126 (codified as amended at I.R.C. §74 Note), as amended by Pub. L. 115–141, div. T, §101(c), Mar. 23, 2018, 132 Stat. 348, 1151, providing a transitional rule for qualified payments of patrons of Cooperatives.

Proposed §1.199A-7(h)(3) and §1.199A-8(h)(3) provide that the Cooperative must identify in a written notice to its patrons that a section 199A(a) deduction cannot be claimed for qualified payments that otherwise would constitute QBI in the patron's trade or business in a taxable year in which the qualified payments remain subject to former section 199. The Cooperative must report this information on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

II. Proposed §1.199A-8, Deduction for Income Attributable to Domestic Production Activities of Specified Cooperatives

A. In General

Section 199A(g) provides a deduction for Specified Cooperatives and their patrons that is similar in many respects to the deduction under former section 199. Proposed §1.199A-8 provides definitions relating to the section 199A(g) deduction, establishes the criteria that a Specified Cooperative must satisfy to be eligible to claim the section 199A(g) deduction, and sets forth the necessary steps for a Specified Cooperative to calculate the section 199A(g) deduction.

B. Definitions

Proposed §1.199A-8 defines the terms patron, Specified Cooperative, and agricultural or horticultural products. In defining patron, the Treasury Department and the IRS sought consistency with the rules under subchapter T of chapter 1 of subtitle A of the Code. Thus, the rules in proposed §1.199A-8 cross-reference the definition of patron found in §1.1388-1(e).

The definition of Specified Cooperative is consistent with the definition set forth in section 199A(g)(4). This definition is different from the definition of Specified Cooperative as originally provided by section 11011(a) of the TCJA (former section 199A(g)(3)), as it no longer includes a Cooperative solely engaged in the provision of supplies, equipment, or services to farmers or other Specified Cooperatives (former section 199A(g)(3)(C)).

Proposed §1.199A-8(a)(4) defines agricultural or horticultural products as agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926, 44 Stat. 802 (1926). Agricultural or horticultural products also include aquatic products that are farmed whether by exempt or nonexempt Specified Cooperatives. See Rev. Rul. 64-246, 1964-2 C.B. 154. In addition, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted (MPGE) by the Specified Cooperative. See Joint Committee Report, at 23, footnote 120.

Agricultural or horticultural products do not include intangible property. For example, an agricultural or horticultural product includes a seed that is grown, but does not include an intangible property right to reproduce a seed for sale. This exclusion of intangible property does not apply to intangible characteristics of any particular agricultural or horticultural product. For example, gross receipts from the sale of different varieties of oranges would all qualify as DPGR from the disposition of agricultural or horticultural products (assuming all other requirements of section 199A(g) are met). However, gross receipts from the license of the right to produce and sell a certain variety of oranges would be considered separate from the tangible oranges themselves and therefore not gross receipts from an agricultural or horticultural product.

This exclusion is consistent with former section 199, which excluded intangible property other than computer software, any property described in section 168(f)(4) (sound recordings), and qualified film products.

The Treasury Department and the IRS considered a similar but alternative definition of agricultural or horticultural products as agricultural, horticultural, viticultural, and dairy products, livestock and poultry, bees, forest products, fish and shellfish, and any products thereof, including processed and manufactured products, and any and all products raised or produced on farms and any processed or manufactured product thereof within the meaning of the Agricultural Marketing Act of 1946, 60 Stat. 1091 (1946). While very similar to the definition set forth in these proposed rules, the Treasury Department and the IRS proposed using the definition based on the Cooperative Marketing Act of 1926, which specifically concerns cooperatives, unlike the Agricultural Marketing Act of 1946, which concerns the marketing and distribution of agricultural products.

The Treasury Department and the IRS also considered an alternative definition of agricultural or horticultural products based on general regulations under the Commodity Exchange Act. The Commodity Futures Trading Commission defines agricultural commodities as wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, but not onions; other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, animal feed or natural fiber; tobacco, products of horticulture, and such other commodities used or consumed by animals or humans. 17 CFR 1.3. The Treasury Department and the IRS concluded that this definition was too narrow, because it is limited to products that can be commodities.

The Treasury Department and the IRS are considering alternative definitions of agricultural or horticultural products to address concerns that the definition could be interpreted inconsistently with the ordinary meaning of agricultural or horticultural products. A clarification of the definition that is under consideration is the limitation of agricultural or horticultural products to products acquired from original producers, such as farmers, planters, ranchers, dairy farmers, or nut or fruit growers, and products thereof that are MPGE by Specified Cooperatives. The Treasury Department and the IRS request comments on whether the original producer approach being considered would be appropriate, as well as other approaches to defining agricultural or horticultural products. The Treasury Department and the IRS also request comments on the impact, if any, of the proposed definition on which products are MPGE by Specified Cooperatives.

A Specified Cooperative's gross receipts from the disposition of agricultural or horticultural products qualify as DPGR if the products were MPGE by the Specified Cooperative in whole or significant part within the United States. The proposed regulations define in whole or significant part for these purposes in proposed §1.199A-

9(h) and provide a 20 percent safe harbor for such determination in proposed §1.199A-9(h)(3).

The definition of gross receipts in proposed §1.199A-8(b)(2)(iii) is essentially the same as in §1.199-3(c) issued under former section 199, except that this definition has been modified by removing references to section 1031 (exchange of real property held for productive use or investment) and tax-exempt interest within the meaning of section 103 (interest on State and local bonds). The reference to section 1031 is removed because that provision now applies only to real property. The section 199A(g) deduction is based on gross receipts derived from the disposition of agricultural or horticultural products and section 199A(g)(3)(D)(i) expressly excludes gross receipts derived from the disposition of land from DPGR. The reference to tax-exempt interest under section 103 is removed because it is appropriate for the definition of gross receipts to include only gross receipts that are taken into account in computing gross income under the Cooperative's methods of accounting used for Federal income tax purposes for the taxable year.

The Treasury Department and the IRS welcome comments regarding all aspects of these proposed definitions, including whether there is an alternative or more appropriate definition of Specified Cooperative or agricultural or horticultural products, and clarification of when MPGE is performed in whole or significant part in the United States that would provide greater certainty for taxpayers in complying with, and the IRS in administering, the requirements for claiming the section 199A(g) deduction. The Treasury Department and the IRS also welcome comments on the appropriateness of the 20 percent safe harbor in proposed §1.199A-9(h)(3).

C. Steps for Calculating Section 199A(g) Deduction

Proposed §1.199A-8 sets forth four required steps to determine the amount of a nonexempt Specified Cooperative's section 199A(g) deduction and provides rules to determine the amount of an exempt Specified Cooperative's section 199A(g) deduction.

i. Patronage/nonpatronage Split

The first step under the rules of proposed §1.199A-8 for calculating the section 199A(g) deduction requires nonexempt Specified Cooperatives to identify the gross receipts and related deductions (other than a deduction under section 199A(g)) that are from patronage sources and from nonpatronage sources. Specified Cooperatives must separate their patronage and nonpatronage gross receipts and related deductions when determining taxable income and allocating expenses between patronage and nonpatronage income to claim the tax deductions under section 1382(b) and (c). Cooperatives that have gross receipts only from patronage sources will be unaffected. Accordingly, the proposed regulations' requirement to divide patronage/nonpatronage gross receipts and related deductions should not significantly impact the existing allocation requirements applicable to Specified Cooperatives.

This step is expressly included in these proposed rules because proposed §1.199A-8 provides that for all purposes of the section 199A(g) deduction, nonexempt Specified Cooperatives may use only patronage gross receipts and related deductions to calculate DPGR, QPAI (including oil-related QPAI), taxable income, and the W-2 wage limitation.

Separating a nonexempt Specified Cooperative's patronage items from its nonpatronage items is consistent with the structure and intent of section 199A.

Section 199A in its entirety is structured to give businesses that are not operating as C corporations a deduction that corresponds to the TCJA's reduction of the top corporate rate of tax under section 11. C corporations are expressly prohibited under section 199A(a) from claiming a section 199A(a) deduction, and under section 199A(g)(2)(D)(i) from claiming a section 199A(g) deduction. Although section 199A(g) provides a deduction for Specified Cooperatives, the statutory prohibitions preventing C corporations from benefiting under section 199A(g) (which were absent from the statutory text of former section 199) are in conflict with permitting a section 199A(g) deduction for the nonpatronage business of a nonexempt Specified Cooperative. Instead, nonpatronage source income of a nonexempt Specified Cooperative receives an alternate benefit shared by other C corporations: the TCJA's reduction of the top rate of tax under section 11 from 35 percent to 21 percent.

Moreover, the 2018 Act amended section 199A to address concerns that the TCJA created an unintended incentive for farmers and other producers to sell their agricultural or horticultural products to Cooperatives over independent buyers. The amendment to section 199A was intended to ensure a level playing field between Cooperatives and independent buyers. Without the split between patronage and nonpatronage businesses, Specified Cooperatives that may benefit from both a section 199A(g) deduction (from which taxpayers other than Specified Cooperatives cannot benefit) and the reduced corporate tax rate on nonpatronage business would be significantly advantaged over independent buyers who could benefit only from the reduced corporate tax rate under section 11.

Accordingly, the Treasury Department and the IRS have determined that it is appropriate to limit the source of the gross receipts and related deductions taken into account for purposes of the section 199A(g) deduction for nonexempt Specified Cooperatives to items properly allocated to a nonexempt Specified Cooperative's patronage business. The Treasury Department and the IRS request comments regarding these proposed rules, including comments explaining any policy rationale that would justify treating the nonpatronage business of a nonexempt Specified Cooperative differently from the business operations of any other C corporation subject to the tax imposed under section 11.

ii. Identifying Patronage DPGR

The second step set forth in proposed §1.199A-8 is for nonexempt Specified Cooperatives to identify patronage gross receipts that qualify as DPGR. The rules in proposed §1.199A-8 point nonexempt Specified Cooperatives to proposed §1.199A-9 for additional information on DPGR. The rules in proposed §1.199A-9 do not refer to gross receipts from patronage or nonpatronage business because the rules only provide additional information supplementing the determination of DPGR from dispositions of agricultural or horticultural products. When applying §1.199A-9, which occurs after step 1 in §1.199A-8, the only gross receipts of a nonexempt Specified Cooperative considered would be those derived from patronage sources. Proposed §1.199A-9 is essentially the same as §§1.199-1 and 1.199-3 issued under former section 199, adjusted to apply to Specified Cooperatives.

iii. Calculating Patronage QPAI

The third step set forth in proposed §1.199A-8 is for nonexempt Specified Cooperatives to calculate QPAI (including oil-related QPAI) from only their patronage DPGR. To do this, nonexempt Specified Cooperatives must determine COGS and other expenses, losses, or deductions that are allocable to patronage DPGR. Nonexempt Specified Cooperatives are directed to consult proposed §1.199A-10 for additional information on making these allocations. Proposed §1.199A-10 does not refer to patronage or nonpatronage QPAI or DPGR because it only provides additional information supplementing the QPAI calculation. Proposed §1.199A-10 is essentially the same as §1.199-4 issued under former section 199, adjusted to apply to Specified Cooperatives.

iv. Calculating Patronage Section 199A(g) Deduction

The fourth and final step set forth in proposed §1.199A-8 is for nonexempt Specified Cooperatives to calculate their section 199A(g) deduction, which is equal to 9 percent of the lesser of QPAI or taxable income, and subject to the W-2 wage limitation. Nonexempt Specified Cooperatives are directed to consult proposed §1.199A-11 for additional information on the W-2 wage limitation. Proposed §1.199A-11 does not refer to patronage or nonpatronage QPAI, taxable income, or W-2 wages because it only provides additional information supplementing the W-2 wage limitation. Proposed §1.199A-11 is essentially the same as §1.199-2 issued under former section 199, adjusted to apply to Specified Cooperatives.

v. Exempt Specified Cooperatives

Proposed §1.199A-8(c) provides that exempt Specified Cooperatives calculate two separate section 199A(g) deductions, one based on gross receipts and related deductions from patronage sources, and one based on gross receipts and related deductions from nonpatronage sources. Like a nonexempt Specified Cooperative, an exempt Specified Cooperative earns patronage income that is not taxed to the extent of any section 1382(b) deduction for patronage distributions made to patrons. Exempt Specified Cooperatives are also not taxed on any nonpatronage income to the extent of any section 1382(c) deduction for nonpatronage distributions. Unlike the usual taxation of C corporations, the section 1382 deductions allow an exempt Specified Cooperative to be treated more like a passthrough entity by reducing the exempt Specified Cooperative's patronage and nonpatronage income. It is therefore appropriate that the exempt Specified Cooperatives may take a section 199A(g) deduction on both patronage and nonpatronage income that could be deducted under section 1382(b) and (c)(2).

As described earlier, calculating two section 199A(g) deductions is consistent with the administration of former section 199. To calculate the two section 199A(g) deductions, an exempt Specified Cooperative is required under proposed §1.199A-8 to perform steps two through four twice, first using only its patronage gross receipts and related deductions and second using only its nonpatronage gross receipts and related deductions. An exempt Specified Cooperative cannot combine, merge, or net patronage and nonpatronage items at any step in determining its patronage section 199A(g) deduction and its nonpatronage section 199A(g) deduction.

D. Special Rule for Oil-Related QPAI

Section 199A(g)(5)(E) contains a special rule for Specified Cooperatives with oil-related QPAI, which requires a reduction by 3 percent of the least of oil-related QPAI, QPAI, or taxable income of the Specified Cooperative for the taxable year. The language of this rule is the same as the language used in former section 199(d)(9). Former section 199(d)(9), which applied to taxable years beginning after December 31, 2008, was added by section 401(a), Division B of the Energy Extension Act of 2008, Public Law 110–343, 122 Stat. 3765 (2008). These proposed rules include rules for oil-related QPAI that are similar to those contained in proposed regulations (REG-136459-09) relating to the section 199 deduction published in the *Federal Register* (80 FR 51978) on August 27, 2015 (2015 Proposed Regulations).

The 2015 Proposed Regulations included rules related to a taxpayer's determination of oil-related QPAI (with respect to which no comments were received). Although not finalized, the 2015 Proposed Regulations are the only existing guidance concerning a taxpayer's determination of oil-related QPAI. The preamble to the 2015 Proposed Regulations includes an explanation of the reasons supporting the proposed provisions, and these reasons continue to apply. These include the determination that gross receipts from transportation and distribution of oil are not included in the calculation of oil-related QPAI, unless the gross receipts are considered DPGR under the de minimis rule or an exception for embedded services now contained in proposed §1.199A-9. Gross receipts from transportation and distribution are not included in QPAI and DPGR (unless an exception applies), and therefore it is appropriate to exclude such gross receipts when calculating oil-related QPAI.

E. Rules for Passing Section 199A(g) Deduction to Patrons

Once a Specified Cooperative calculates the section 199A(g) deduction, it may pass on the section 199A(g) deduction to patrons who are eligible taxpayers as defined in section 199A(g)(2)(D), that is, (i) a patron that is other than a C corporation or (ii) a patron that is a Specified Cooperative. Section 199A(g)(2)(A) requires the Specified Cooperative to identify the amount of the section 199A(g) deduction being passed to a patron in a notice (required by proposed §1.199A-8(d)(3)) mailed to the eligible patron during the payment period described in section 1382(d). The amount of the section 199A(g) deduction that a Specified Cooperative can pass through to an eligible taxpayer is limited to the portion of the section 199A(g) deduction that is allowed with respect to the QPAI to which the qualified payments made to the eligible taxpayer are attributable. Section 199A(g)(2)(E) defines qualified payments as those that are included in the eligible taxpayer's income under section 1385(a)(1) and (3) (referencing patronage dividends and per-unit retain allocations). Proposed §1.199A-8 further provides that a Specified Cooperative that receives a section 199A(g) deduction as an eligible taxpayer can take the deduction only against patronage gross income and related deductions, or pass on the deduction to its patrons that are eligible taxpayers. The proposed rules do not allow an exempt Specified Cooperative to pass through any of the section 199A(g) deduction attributable to nonpatronage activities because no QPAI is attributable to any qualified payments. The rules of proposed §1.199A-8 are essentially the same as the rules of §1.199-6, adjusted to include other provisions of the section 199 final regulations as well as proposed rules set forth in the 2015 Proposed Regulations.

F. <u>Cooperative as a Partner in a Partnership</u>

Proposed §1.199A-8(f) provides guidance regarding circumstances in which a Specified Cooperative is a partner in a partnership as described under section 199A(g)(5)(B). The proposed rules provide that the partnership must separately identify and report on the Schedule K-1 to the Form 1065, U.S. Return of Partnership Income, (or any successor form) issued to its partner, unless otherwise provided by the instructions to the Form, the Specified Cooperative's allocable share of gross receipts and related deductions. This allows the Specified Cooperative partner to apply the four steps in proposed §1.199A-8 required to calculate its patronage section 199A(g) deduction (or patronage and nonpatronage section 199A(g) deductions in the case of an exempt Specified Cooperative).

III. <u>Proposed §1.199A-9, Domestic Production Gross Receipts</u>

A. <u>In General</u>

Section 199A(g)(3)(D) defines the term <u>domestic production gross receipts</u> to mean gross receipts of a Specified Cooperative derived from any lease, rental, license, sale, exchange, or other disposition (collectively, a "disposition") of any agricultural or horticultural product which was MPGE (determined after application of section 199A(g)(4)(B)) by the Specified Cooperative in whole or significant part within the United States. Such term does not include gross receipts of the Specified Cooperative derived from a disposition of land or from services. These proposed regulations are based on §1.199-3 issued under former section 199, but remove provisions that would not apply to the disposition of agricultural or horticultural products.

DPGR includes the gross receipts that a Specified Cooperative derives from marketing agricultural or horticultural products for patrons. Section 199A(g)(4)(B) treats marketing Specified Cooperatives as having MPGE any agricultural or horticultural product in whole or significant part within the United States if their patrons have done so. The Treasury Department and the IRS considered whether this rule should apply between Specified Cooperatives and patrons taxed as C corporations. These proposed regulations allow attribution to apply as provided in section 199A(g)(4)(B) because the statute does not distinguish between types of patrons. However, these proposed regulations do not allow a Specified Cooperative to pass through to a C corporation any of the section 199A(g) deduction of the Specified Cooperative attributable to the disposition of such agricultural or horticultural products. This is because, under section 199A(g)(2)(D), taxpayers taxed as C corporations are not eligible to claim a section 199A(g) deduction from the Specified Cooperative. These proposed regulations incorporate the rules from §1.199-1(d)(1) through (3) and (e), issued under former section 199, as applicable. These rules relate to the allocation of gross receipts between DPGR and non-DPGR, and the determination of whether an allocation method is reasonable. Further, the rules include provisions permitting Specified Cooperatives to treat de minimis gross receipts as DPGR or non-DPGR without allocating such gross receipts, and a provision permitting the use of historical data to allocate gross receipts for certain multiple-year transactions. The Treasury Department and the IRS welcome comments regarding all aspects of these proposed rules. When incorporating these concepts from the former section 199 regulations, the Treasury Department and the IRS determined that the appropriate section of these proposed regulations in which to include such guidance was proposed §1.199A-9. This is not a substantive change, but rather a reorganization to improve clarity.

B. Definition of Manufactured, Produced, Grown, Extracted

The definition of the term MPGE is included in proposed §1.199A-9 and is generally consistent with the definition in §1.199-3(e)(1). However, these proposed regulations revise the rule in §1.199-3(e)(2) by removing the concept of minor assembly. In the 2015 Proposed Regulations, the Treasury Department and the IRS requested comments on defining the term minor assembly because of the difficulty in identifying a widely applicable objective test. Based on the comments received and the restriction on the section 199A(g) deduction to agricultural or horticultural products, proposed §1.199A-9 does not include the term minor assembly included in §1.199-3(e)(2). This exclusion does not impact a taxpayer’s obligation to meet all of the other requirements to qualify for the section 199A(g) deduction. The Treasury Department and the IRS request comments on whether the concept of minor assembly should be retained and, if so, how this term should be defined.

C. By the Taxpayer

With respect to the phrase “by the taxpayer” as used in section 199A(g)(3)(D)(i), these proposed regulations adopt the rule from §1.199-3(f)(1) as applicable, rather than the rule in the 2015 Proposed Regulations. In a contract manufacturing arrangement, this means that a Specified Cooperative must have the benefits and burdens of ownership of the agricultural or horticultural product during the period in which the MPGE activity occurs in order for the Specified Cooperative to be treated as engaging in such MPGE activity. The 2015 Proposed Regulations provided a different rule for contract manufacturing arrangements. The 2015 Proposed Regulations provided that if a qualifying activity is performed under a contract, then the party that performs the qualifying activity is the taxpayer for purposes of section 199(c)(4)(A)(i). Under the rule in the 2015 Proposed Regulations, a Specified Cooperative that contracts with another party for the MPGE of an agricultural or horticultural product would never qualify as "the taxpayer" for purposes of the section 199A(g) deduction. This result fails to provide any incentive for Specified Cooperatives to retain the benefits and burdens of ownership and to ensure that production occurs within the United States. Therefore, to maintain such an incentive, the proposed regulations maintain the rule from §1.199-3(f)(1). The Treasury Department and the IRS request comments on the continued use of the rule from §1.199-3(f)(1).

D. Other Provisions in Proposed §1.199A-9

The remainder of the rules in proposed §1.199A-9 are based on the existing regulations in §1.199-3. These rules should be interpreted in a manner consistent with the interpretation under former section 199. The Treasury Department and the IRS request comments on any conception or definition that in application would be over or under-inclusive under the proposed regulations, or any instances where they should interpret the rules differently from the interpretation under former section 199.

IV. Proposed §1.199A-10, Costs Allocable to DPGR

Proposed §1.199A-10 provides guidance on the allocation of costs to DPGR. This section provides rules for allocating a taxpayer's COGS, as well as other expenses, losses, and deductions properly allocable to DPGR. These proposed regulations are based on and follow the section 199 regulations in §1.199-4.

V. Proposed §1.199A-11, Wage Limitation

Proposed §1.199A-11 provides guidance regarding the W-2 wage limitation on the section 199A(g) deduction. A notice of proposed revenue procedure, Notice 2019-27, 2019-16 IRB, which proposes a draft revenue procedure providing three proposed methods that Specified Cooperatives may use for calculating W-2 wages, is being issued concurrently with this notice of proposed rulemaking. The guidance contained in the notice of proposed revenue procedure is necessary because changes may be made to the underlying Form W-2, Wage and Tax Statement, on a more frequent basis than updates to the regulations under section 199A(g), for regulatory and statutory reasons independent of section 199A. The three proposed methods for calculating W-2 wages in the notice are substantially similar to the methods provided in Rev. Proc. 2006-47, 2006-2 C.B. 869 (relating to the section 199 deduction), and Rev. Proc. 2019-11, 2019-09 IRB 742 (relating to the section 199A(a) deduction). The Treasury Department and the IRS propose these methods in a notice of proposed revenue procedure rather than in the notice of proposed rulemaking to maintain consistency with the rules under former section 199 and the rules under section 199A. The notice of proposed revenue procedure invites comments from the public.

Under the proposed regulations, W-2 wages for the purpose of the wage limitation in section 199A(g) are generally determined in a manner that is similar to the manner in which W-2 wages are determined for the purpose of the deduction under section 199A(a) (that is, using the definition of W-2 wages under section 199A(b)(4)), with three significant differences. First, section 199A(g)(1)(B)(ii) provides that W-2 wages are determined without regard to section 199A(b)(4)(B), which excludes from the definition amounts not properly allocable to QBI for purposes of section 199A(c)(1). Second, W-2 wages under section 199A(g) do not include any amount that is not properly allocable to DPGR. Finally, W-2 wages under section 199A(g) do not generally include any remuneration paid for services in the commonwealth of Puerto Rico and other United States territories. Specifically, section 199A(g)(1)(B)(ii) provides that W-2 wages are determined in the same manner as under section 199A(b)(4), and section 199A(b)(4)(A) defines wages as amounts described in section 6051(a)(3) and (8). The amounts described in section 6051(a)(3) are "wages as defined in section 3401(a)." Section 3401(a)(8) generally excludes from the definition of wages in section 3401(a) wages paid with respect to employment in the commonwealth of Puerto Rico and other United States territories. Therefore, wages paid with respect to employment in the commonwealth of Puerto Rico and other United States territories are generally not W-2 wages within the meaning of section 199A(b)(4)(A). This contrasts with the section 199A(a) deduction for which section 199A(f)(1)(C)(ii) allows certain taxpayers with QBI from sources within the commonwealth of Puerto Rico (section 199A(f)(1)(C)(ii) applies only to Puerto Rico and not to other United States territories) to compute section 199A(b)(4) W-2 wages without regard to section 3401(a)(8). Since the section 199A(g) deduction is determined based on QPAI, not QBI, section 199A(f)(1)(C)(ii) does not apply to the deduction under section 199A(g). Given the distinction between QBI and QPAI on which the section 199A(a) and section 199A(g) deductions are respectively provided, and the absence of a provision similar to 199A(f)(1)(C)(ii) with respect to QPAI, the Treasury Department and the IRS have determined that remuneration paid with respect to employment in the commonwealth of

Puerto Rico cannot be used in determining W-2 wages for purposes of section 199A(g). The Treasury Department and the IRS request comments with respect to this determination.

VI. Proposed §1.199A-12, EAG Rules

Proposed §1.199A-12 provides guidance on the application of section 199A(g) to an EAG under section 199A(g)(5)(A)(iii) that includes a Specified Cooperative. Unlike the section 199 deduction, the section 199A(g) deduction is limited to Specified Cooperatives. These proposed regulations address how the rules separating patronage and nonpatronage income and deductions apply in the context of an EAG. Proposed §1.199A-12 provides that in the case of nonexempt Specified Cooperatives, attribution between the members of an EAG is allowed provided the DPGR and related deductions are patronage. In the case of exempt Specified Cooperatives, attribution is allowed in all events because exempt Specified Cooperatives are allowed to take a separate 199A(g) deduction on both their patronage and nonpatronage income.

Proposed §1.199A-12 also provides certain rules for partnerships owned by an EAG as described in section 199A(g)(5)(A)(ii).

VII. Proposed §1.1388-1(f)

Proposed §1.1388-1(f) sets forth a definition of patronage and nonpatronage that is consistent with the current case law under section 1388. Specifically, the proposed definition adopts the directly related test, which is a fact specific test for determining whether income and deductions of a Cooperative are patronage or nonpatronage. The Treasury Department and the IRS request comments with respect to this definition.

VIII. Proposed Removal of Section 199 Regulations and Withdrawal of 2015 Proposed Regulations

In light of the TCJA, the Treasury Department and the IRS propose to remove the section 199 regulations (§§1.199-0 through 1.199-9) and withdraw the 2015 Proposed Regulations because the regulations interpret a provision of the Code that has been repealed for taxable years beginning after December 31, 2017.

The proposed removal of these regulations is unrelated to the substance of the rules in the regulations, and no negative inference regarding the stated rules should be made. Such regulations are proposed to be removed from the Code of Federal Regulations (CFR) solely because they have no future applicability. Removal of these regulations is not intended to alter any non-regulatory guidance that cites to or relies upon these regulations. These regulations as contained in 26 CFR part 1, revised April 1, 2019, remain applicable to determining eligibility for the section 199 deduction for any taxable year that began before January 1, 2018. The beginning date of the taxable year of a partnership, S corporation, or a non-grantor trust or estate, rather than the taxable year of a partner, shareholder, or beneficiary is used to determine items that are taken into account for purposes of calculating a section 199 deduction. This is consistent with the initial application of section 199 in 2005. Items arising from a passthrough entity that had a fiscal year beginning before 2005 were not taken into account by calendar-year partners for purposes of the section 199 deduction. Public Law 109-135, section 102(a) (Gulf Opportunity Zone Act of 2005). Further, when section 199 was amended to narrow the definition of W-2 wages, the amendment was effective for taxable years beginning after May 17, 2006. See Public Law 109-222, section 514(a) (Tax Increase Prevention and Reconciliation Act of 2005). Under the transition rule in §1.199-5(b)(4), partners and partnerships used the taxable year of the partnerships to determine the applicable definition of W-2 wages, and there are similar rules in §1.199-5(c)(4) for S corporations and §1.199-5(e)(3) for non-grantor trusts and estates.

Proposed Effective/Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the *Federal Register*, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the *Federal Register*.

Consistent with authority provided by section 7805(b)(1)(A), the proposed regulations are proposed to apply to taxable years beginning after the date of publication of a Treasury decision adopting these rules as final regulations in the *Federal Register*. Taxpayers may rely upon these proposed regulations, in their entirety, before the date of publication of the Treasury Decision adopting these rules as final regulations in the *Federal Register*.

Special Analyses

I. Regulatory Planning and Review – Economic Analysis

Executive Orders 13563 and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

These proposed regulations have been designated by the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. OIRA has determined that the proposed rulemaking is significant and subject to review under Executive Order 12866 and section 1(b) of the Memorandum of Agreement. Accordingly, the proposed regulations have been reviewed by the Office of Management and Budget.

In addition, the Treasury Department and the IRS expect the proposed regulations, when final, to be an Executive Order 13771 regulatory action and request comment on this designation.

A. Background and Overview

The TCJA repealed section 199, which provided a deduction for income attributable to domestic production activities. In its place it created section 199A, which provides a deduction for qualified business income derived from passthrough businesses – such as sole proprietorships, partnerships, and S corporations – engaged in domestic trades or businesses. While the repealed section 199 deduction was generally available to all taxpayers, the section 199A deduction is available only to taxpayers other than C corporations. On March 23, 2018, the 2018 Act modified section 199A(g) to provide deductions for Specified Cooperatives and their patrons that are substantially similar to those under the repealed section 199 deduction. Accordingly, these regulations generally formalize prior and current practices based on the rules under former section 199. The 2018 Act also added section 199A(b)(7), which requires patrons of Specified Cooperatives to reduce their section 199A(a) deduction if those patrons receive qualified payments from Specified Cooperatives.

The estimated number of Cooperatives affected by the 2018 Act and these proposed regulations is 9,000, including approximately 2,000 Specified Cooperatives, based on 2017 tax filings.

B. Need for the Proposed Regulations

The proposed regulations provide guidance regarding the application of sections 199A(a), 199A(b)(7), and 199A(g) to Cooperatives, Specified Cooperatives, and their patrons. The proposed regulations are needed because the 2018 Act introduced a number of terms and calculations. Patrons, Cooperatives, and Specified Cooperatives would benefit from greater specificity regarding these and other items.

C. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

2. Economic Rationale for Issuing Guidance for the 2018 Act

The Treasury Department and the IRS anticipate that the issuance of guidance pertaining to sections 199A(a), 199A(b)(7), and 199A(g) of the 2018 Act to

Cooperatives, Specified Cooperatives, and their patrons will provide a net economic benefit to the overall U.S. economy.

The proposed regulations clarify a number of concepts related to the section 199A(a) deduction for patrons of Cooperatives, provide guidance to patrons of Specified Cooperatives who may be required to reduce their section 199A(a) deduction under section 199A(b)(7), and provide guidance to Specified Cooperatives on the section 199A(g) deduction on income attributable to their domestic production activities. In the absence of guidance, affected taxpayers would have to calculate their tax liability without the definitions and clarifications provided by the proposed regulations, a situation that is generally considered more burdensome and could lead to greater conflicts with tax administrators. Thus, the Treasury Department and the IRS project that the proposed regulations will reduce taxpayer compliance burden and the costs of tax administration relative to not issuing any such guidance.

This guidance also ensures that section 199A deductions are calculated similarly across taxpayers, avoiding situations where one taxpayer receives preferential treatment over another for fundamentally similar economic activity. For example, in the absence of these proposed regulations, a Specified Cooperative may have uncertainty over what type of income is eligible for the section 199A(g) deduction. If a Specified Cooperative claimed the section 199A(g) deduction on income that already benefits from a lower corporate tax rate, this would confer an unintended economic benefit to the Specified Cooperative over other C corporations performing identical activities that only benefit from a lower corporate tax rate. As discussed further below, this guidance prevents the introduction of distortions of economic decisions in the agricultural or horticultural sector.

In the absence of these proposed regulations, uncertainty over statutory interpretation could lead to economic losses to the extent that taxpayers interpret the statute in ways that are inconsistent with the statute’s intents and purposes. For example, a Specified Cooperative may pursue a project involving a certain product that is only profitable if that product is deemed “agricultural or horticultural” and thus eligible for the section 199A(g) deduction. If, in fact, this product is ineligible for the deduction based on the intents and purposes of the statute, then the project should not have been pursued and this results in an economic loss. Alternatively, without a definition of “agricultural or horticultural,” a Specified Cooperative may incorrectly assume that a project is not eligible for the deduction and not pursue the project, which could also result in an economic loss. In such cases, guidance provides value by bringing economic decisions closer in line with Congress’ intent or, when such intent is broad, with decisions that are economically efficient contingent on the overall Code. While no guidance can fully curtail all inaccurate interpretations of the statute, the proposed regulations significantly mitigate the chance for such interpretations and thereby increase economic efficiency. Due to the lack of readily available data, the Treasury Department and the IRS have not estimated the increase in United States economic activity that would arise from the proposed guidance.

The Treasury Department further projects that the issuance of guidance will reduce taxpayer compliance burden and the costs of tax administration relative to a no-action baseline. Due to the lack of readily available data, the Treasury Department has not estimated the decrease in taxpayer compliance burden nor tax administration costs arising from the issuance of guidance. The Treasury Department and the IRS request comments and information that can allow estimation of economic impacts and any changes in taxpayer compliance burden resulting from the proposed guidance.

3. Economic Analysis of Specific Provisions

The proposed regulations embody certain regulatory decisions that reflect necessary regulatory discretion. These decisions specify more fully how the 2018 Act is to be implemented.

The Treasury Department and the IRS solicit comments on the economic impacts of each of the items discussed in this section and of any other items of the proposed regulations not discussed in this section. The Treasury Department and the IRS particularly solicit comments that provide data, other evidence, or models that could enhance the rigor of the process by which provisions might be developed for the final regulations.

i. Determining Section 199A(g) Deduction

Specified Cooperatives are taxed differently depending on whether they are exempt (qualified as a cooperative under section 521) or nonexempt (qualified under rules elsewhere in the Code) and also whether their income is from patronage (generally related to the cooperative's marketing, purchasing, or services activities) or nonpatronage sources. In the case of exempt Specified Cooperatives patronage and nonpatronage source income is subject to a single level of tax at the patron level. Whereas, for nonexempt Specified Cooperatives only patronage source income is subject to a single level of tax at the patron level; nonpatronage source income is subject to a double level of tax, similar to other C corporations. Because the Code does not define patronage and nonpatronage source income, proposed §1.1388-1(f) sets forth a definition of patronage and nonpatronage that is consistent with the current state of federal case law. Specifically, the proposed definition adopts the directly related test, which is a fact specific test for determining whether income and deductions of a Cooperative are patronage or nonpatronage. Specifying a definition that is consistent with current case law will help to minimize the economic impacts of these proposed regulations. The Treasury Department and the IRS request comments with respect to this definition.

The TCJA reduced the corporate tax rate for C corporations under section 11 and provided the section 199A deduction for domestic businesses operated as sole proprietorships or through partnerships, S corporations, trusts, or estates. The TCJA also repealed section 199, which did not preclude deductions on income earned by C corporations. The 2018 Act amended section 199A to address concerns that the TCJA created an unintended incentive for farmers to sell their agricultural or horticultural products to Specified Cooperatives over independent buyers. Specifically, the 2018 Act amended section 199A(g) to allow Specified Cooperatives and their patrons a deduction similar to the former section 199 deduction. Because the section 199A(g) deduction is not intended to benefit C corporations and their shareholders in general, the proposed regulations specify that the section 199A(g) deduction can be claimed on income that can be subject to tax only at the patron level. Under the proposed regulations, non-exempt Specified Cooperatives may not claim the section 199A(g) deductions on income that cannot be paid to patrons and deducted under section 1382(b) and exempt

Specified Cooperatives may not claim section 199A(g) deductions on income that cannot be paid to patrons and deducted under sections 1382(b) or 1382(c)(2).

In the absence of these proposed regulations, a Specified Cooperative may have uncertainty as to whether non-patronage source income, which would be taxed in the same manner as a C corporation, could receive both the lower corporate tax rate and be further offset by a section 199A(g) deduction. Other C corporations performing identical activities would only benefit from the lower corporate tax rate.

The Treasury Department and the IRS have determined that this potential uncertainty as to tax treatment could distort economic decisions in the agricultural or horticultural sector. The proposed regulations avoid this outcome, promoting a more efficient allocation of resources by providing more uniform incentives across taxpayers.

ii. Definition of Agricultural or Horticultural Products

Proposed §1.199A-8(a)(4) defines agricultural or horticultural products as agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926. Agricultural or horticultural products also include aquatic products that are farmed as well as fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are MPGE by the Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property, since agricultural or horticultural products were considered a subset of tangible property under former section 199. Intangible property (defined in §1.199-3(j)(2)(iii)) was a separate category of property and gross receipts from intangible property did not qualify as DPGR.

The Treasury Department and the IRS considered other definitions of agricultural or horticultural products but determined that taxpayer burden and tax administration costs would be lowest under a definition that was consistent with extant law.

For example, the Treasury Department and the IRS considered a similar but alternative definition of agricultural or horticultural products as agricultural, horticultural, viticultural, and dairy products, livestock and poultry, bees, forest products, fish and shellfish, and any products thereof, including processed and manufactured products, and any and all products raised or produced on farms and any processed or manufactured product thereof within the meaning of the Agricultural Marketing Act of 1946. While very similar to the definition in these proposed rules, the Treasury Department and the IRS proposed using the definition based on the Cooperative Marketing Act of 1926, which specifically concerns cooperatives and with which Specified Cooperatives are familiar, unlike the Agricultural Marketing Act of 1946, which concerns the marketing and distribution of agricultural products without reference to Cooperatives. The Treasury Department and the IRS looked to the United States Department of Agriculture (USDA) for definitions because there is no definition of agricultural or horticultural products in the Internal Revenue Code or Income Tax Regulations and because the USDA has expertise concerning Specified Cooperatives and because Specified Cooperatives are likely familiar with USDA law.

The Treasury Department and the IRS also considered an alternative definition of agricultural or horticultural products based on the definition of agricultural commodities within the meaning of general regulations under the Commodity Exchange Act. The Treasury Department and the IRS concluded that this definition was too narrow, because it is limited to products that can be commodities. The use of this narrow definition would have restricted the range of products for which the section 199A(g) deduction would be otherwise be available.

The Treasury Department and the IRS request comments on other approaches to defining agricultural or horticultural products. The Treasury Department and the IRS did not attempt to provide quantitative estimates of the revenue effects or economic consequences of different designations of agricultural or horticultural products because suitable data are not readily available at this level of detail. The Treasury Department and the IRS request comments that can inform such estimation.

iii. De Minimis Threshold

In general, proposed §1.199A-9 requires that Specified Cooperatives allocate gross receipts between domestic production gross receipts (DPGR) and non-DPGR. However, proposed §1.199A-9(c)(3) includes a de minimis provision that allows Specified Cooperatives to allocate total gross receipts to DPGR if less than 5 percent of total gross receipts are non-DPGR or to allocate total gross receipts to non-DPGR if less than 5 percent of total gross receipts are DPGR. The Treasury Department and the IRS chose to include a de minimis rule to reduce compliance costs and simplify tax filing relative to an alternative of no de minimis rule. The de minimis threshold modestly reduces compliance costs for businesses with relatively small amounts of non-DPGR or DPGR by allowing them to avoid allocating receipts between DPGR and non-DPGR activities. The de minimis threshold is unlikely to create any substantial effects on market activity because any change in the ratio of DPGR to non-DPGR will be localized around the threshold, meaning that the movement will be a small fraction of receipts to get below the de minimis threshold.

The thresholds provided in the proposed regulations are based on the thresholds set forth in §1.199-1(d)(3). The Treasury Department and the IRS maintained the de minimis rule from the final regulations under former section 199 because the 2018 Act directed that regulations concerning the section 199A(g) deduction be based on the regulations applicable to Cooperatives and their patrons under former section 199. The Treasury Department and the IRS considered changes in the de minimis provisions but determined that changing these from provisions that were previously available would lead to taxpayer confusion. Because the de minimis provision exempts taxpayers from having to perform certain allocations, the Treasury Department and the IRS do not have sufficient information on taxpayers' use of this exemption under former section 199 to perform a quantitative analysis of the impacts of the de minimis provision.

The Treasury Department and the IRS solicit comments on the de minimis thresholds and particularly request comments that provide data, other evidence, and models that can enhance the rigor of the process by which such thresholds might be determined for the final regulations while maintaining consistency with the statute's directive that the thresholds be based on regulations issued under former section 199.

iv. Reporting Requirements

Proposed §1.199A-7(c) and (d) provide that, when a patron conducts a trade or business that receives distributions from a Cooperative, the Cooperative is required to provide the patron with qualified items of income, gain, deduction, and loss and specified service trade or business (SSTB) determinations with respect to those distributions. This increases the compliance burden on such Cooperatives. However, in the absence of these proposed regulations, the burden for determination of the amount of distributions from a Cooperative that constitute qualified items of income, gain, deduction, and loss from a non-SSTB and an SSTB would lie with the patron. Because patrons are less well positioned to acquire the relevant information to determine whether distributions from a Cooperative are qualified items of income, gain, deduction, and loss and whether items that would otherwise qualify are from an SSTB, the Treasury Department and the IRS expect that these proposed regulations will reduce overall compliance costs relative to an alternative approach of not introducing a reporting requirement.

v. Allocation Safe Harbor

If a patron receives both qualified payments and payments that are not qualified payments in a qualified trade or business, the patron must allocate those items and related deductions using a reasonable method based on all of the facts and circumstances. The proposed regulations provide a safe harbor that allows patrons who receive qualified payments in addition to other income to use a simpler method to allocate business expenses and W-2 wages between qualified payments and other gross receipts to calculate the section 199A(b)(7) reduction to the section 199A(a) deduction. The safe harbor allocation method allows patrons to allocate by ratably apportioning business expenses and W-2 wages based on the proportion that the amount of qualified payments bears to the total gross receipts used to determine QBI.

This safe harbor is available to patrons with taxable incomes below the threshold amounts set forth in section 199A(e)(2).

The Treasury Department and the IRS considered an alternative of not allowing a safe harbor but determined that a safe harbor could reduce compliance costs and simplify tax filing. The threshold was set at amounts set forth in section 199A(e)(2) to avoid a proliferation of thresholds applicable to taxpayers claiming a section 199A(a) deduction. Because the threshold amounts are relatively low, the Treasury Department and the IRS expect that the safe harbor would not distort business decisions or reduce revenue to any meaningful extent.

II. <u>Paperwork Reduction Act</u>

The collections of information in these proposed regulations are in proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3), as well as proposed §1.199A-8(d)(3), (f), and (h)(3). The collections of information in proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3), as well as proposed §1.199A-8(d)(3) and (h)(3) will be conducted through Form 1099-PATR, while the collection of information in proposed §1.199A-8(f) will be conducted through Schedule K-1 to Form 1065. In 2018, the IRS released and invited comments on the draft of Form 1065, Schedule K-1. The IRS received no comments on the form during the comment period. Consequently, the IRS made the form available December 6, 2018 for use by the public. On February 26, 2019, the IRS invited comments on Form 1099-PATR and the comment period closed on April 29, 2019. The IRS plans to issue in the near term an additional notice with a thirty-day comment period on Form 1099-PATR. The IRS is contemplating making additional changes to those two forms as discussed below in these proposed regulations .

A. <u>Collections of information conducted through Form 1099-PATR</u>

The collection of information in proposed §1.199A-7(c)(3) requires the Cooperative to inform its patron of the amount of any distribution to the patron that constitutes qualified items of income, gain, deduction, and loss from a non-SSTB conducted directly by the Cooperative. Not all distributions to patrons are qualified items of income, gain, deduction, and loss because the source of the distribution may not be effectively connected with the conduct of a trade or business within the United States or may include interest income that is not properly allocable to the patron's trade or business. The Cooperative directly conducting the trade or business from which the distribution to the patron originates is in the best position to know how much of the distribution is qualified items of income, gain, deduction, and loss. The Cooperative is also in the best position to know if it is generating income from an SSTB. Accordingly, the collection of information is necessary for the patron to calculate correctly the patron's section 199A(a) deduction for the patron's trade or business.

The collection of information in proposed §1.199A-7(d)(3) requires the Cooperative to inform its patron of the amount of any distributions to the patron that constitutes qualified items of income, gain, deduction, and loss from an SSTB conducted directly by the Cooperative. Accordingly, the collection of information is necessary for the patron to correctly calculate the patron's section 199A(a) deduction for the patron's qualified trade or business.

The collection of information in proposed §1.199A-7(f)(3) is essential for the eligible taxpayer's calculation of the reduction in the eligible taxpayer's section 199A(a) deduction for the eligible taxpayer's trade or business that is required by section 199A(b)(7). Section 199A(g)(2)(A) requires the Specified Cooperative to identify the amount of qualified payments being distributed to an eligible taxpayer and identify the portion of the deduction allowed in a notice mailed to the eligible taxpayer during the payment period described in section 1382(d). Section 199A(b)(7) provides that an eligible taxpayer who receives qualified payments from a Specified Cooperative must reduce the eligible taxpayer's section 199A(a) deduction by an amount set forth in this section. Without the notice described in proposed §1.199A-7(f)(3), the eligible taxpayer cannot calculate the reduction required by section 199A(b)(7).

The collection of information in proposed §1.199A-8(d)(3) is necessitated by section 199A(g)(2)(A). Section 199A(g)(2)(A) permits a Specified Cooperative to pass through an amount of its section 199A(g) deduction to an eligible taxpayer. The amount of the section 199A(g) deduction that the Specified Cooperative is permitted to pass through is an amount that is allocable to the QPAI generated from qualified payments distributed to the eligible taxpayer and identified by such cooperative in a written notice mailed to such taxpayer during the payment period described in section 1382(d). Without the notice required in proposed §1.199A-8(d)(3) the eligible taxpayer would not know that the Specified Cooperative is passing a portion of its section 199A(g) deduction to the eligible taxpayer.

The collections of information in proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) are necessitated by a special transition rule in section 101 of the 2018 Act. Under this transition rule, the repeal of former section 199 for taxable years beginning after December 31, 2017, does not apply to a qualified payment received by a patron from a Specified Cooperative in a taxable year beginning after December 31, 2017, to the extent such qualified payment is attributable to QPAI with respect to which a deduction is allowable to the Specified Cooperative under former section 199 for a taxable year of the Specified Cooperative beginning before January 1, 2018. Such qualified payment remains subject to former section 199 and no deduction is allowed under section 199A(a) or (g) with respect to such qualified payment. Without these collections of information by the Specified Cooperative, the patron has no way of knowing that the patron is barred by the transition rule from using a qualified payment received that is QBI for the patron's trade or business to claim a section 199A(a) deduction for the patron's trade or business.

The collections of information in proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as proposed §1.199A-8(d)(3) and (h)(3) are satisfied by providing information about qualified items of income, SSTB determinations, qualified payments, the section 199A(g) deduction, and the use of qualified payments tied to the former section 199 deduction, as applicable, on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

For purposes of the Paperwork Reduction Act of 1995, (44 U.S.C. 3507(d)) (PRA), the reporting burden associated with proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as proposed §1.199A-8(d)(3) and (h)(3) will be reflected in the PRA Submission associated with Form 1099-PATR (OMB control number 1545-0118). As further discussed in this section, the estimated number of respondents for the reporting burden associated with these information collections is 9,000 based on 2017 tax filings.

B. Collections of information conducted through Schedule K-1, Form 1065

The collection of information in proposed §1.199A-8(f) is required by section 199A(g)(5)(B). This section allows a Specified Cooperative that is a partner in a partnership to use its allocable share of gross receipts and related deductions to calculate its section 199A(g) deduction. The proposed rules provide that the partnership must separately identify and report the allocable share of gross receipts and related deductions on or attached to the Schedule K-1 to the Form 1065 (or any successor form) issued to a Specified Cooperative partner, unless otherwise provided by the instructions to the Form. Without this reporting, the Specified Cooperative partner would not have the information necessary to calculate its section 199A(g) deduction from its activities with the partnership.

The Schedule K-1 to the Form 1065 will be modified to include a mechanism to report the Specified Cooperative partner's allocable share of gross receipts and related deductions. The collection of information in proposed §1.199A-8(f) is satisfied when the partnership provides the required information to its Specified Cooperative partners on or attached to the Schedule K-1 of Form 1065 (or any successor form), unless otherwise provided by the instructions to the Form. For purposes of the PRA, the reporting burden associated with proposed §1.199A-8(f) will be reflected in the PRA Submission associated with Form 1065 (OMB control number 1545-0123). As provided in this section, the estimated number of respondents for the reporting burden associated with these information collections is 407 based on 2017 tax filings.

C. Revised tax forms

The revised tax forms are as follows:

	New	Revision of existing form	Number of respondents
Form 1099-PATR		✓	**9,000**
Schedule K-1 (Form 1065)		✓	**407**

The current status of the PRA submissions related to the tax forms that will be revised as a result of the information collections in the proposed regulations is provided in the accompanying table. As described previously, the burdens associated with proposed §1.199A-7(c)(3), (d)(3), (f)(3), and (h)(3) as well as proposed §§1.199A-8(d)(3) and (h)(3) will be included in the aggregated burden estimates for OMB control number 1545-0118, which represents a total estimated burden time of 509,895 hours and total estimated monetized costs of $44.733 million ($2018). The burdens associated with the information collection in proposed §1.199A-8(f) will be included in the aggregated burden estimates for OMB control number 1545-0123, which represents a total estimated burden time for all forms and schedules of 3.157 billion hours and total estimated monetized costs of $58.148 billion ($2017). The overall burden estimates provided for 1545-0118 and 1545-0123 are aggregate amounts that relate to all information collections associated with the applicable OMB control number.

No burden estimates specific to the forms affected by the proposed regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. Those estimates would need to capture both changes made by the 2018 Act and those that arise out of discretionary authority exercised in the proposed regulations. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. Proposed revisions to these forms that reflect the information collections contained in these proposed regulations will be made available for public comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.htm and will not be finalized until after these forms have been approved by OMB under the PRA.

Form	Type of Filer	OMB Number(s)	Status
Form 1099-PATR	[Business (Legacy Model)]	1545-0118	Existing collection of information approved by OIRA on 6/3/2016. Public comments will be sought on a revised collection of information that will be submitted for OIRA review before 6/30/2019.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201602-1545-024		
Form 1065, Schedule K-1	Business (NEW Model)	1545-0123	Published in the *Federal Register* on 10/11/18. Public Comment period closed on 12/10/18. Approved by OIRA on 12/21/18.
	Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd		

III. <u>Regulatory Flexibility Act</u>

As described in more detail in this section, pursuant to the Regulatory Flexibility Act (RFA), 5 U.S.C. chapter 6, the Treasury Department and the IRS hereby certify that these proposed regulations will not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments on any impact this rule would have on small entities.

A. Proposed §1.199A-7(c)(3) and (d)(3)

Although proposed §1.199A-7(c)(3) and (d)(3) will have an impact on a substantial number of small entities, the economic impact will not be significant. The IRS creates the Business Master File which contains data from Form 1120-C, U.S. Income Tax Return for Cooperative Associations. According to the Business Master File data, in 2017, the IRS received approximately 9,000 Forms 1120-C from Cooperatives. Under the North American Industry Classification System (NAICS), a Cooperative is considered a small entity if it has less than $750,000 in annual gross receipts. Approximately 4,050 (45 percent) of the 9,000 filers of Forms 1120-C reported annual gross receipts of less than $750,000. Therefore, a substantial number of small entities are affected by the requirements in proposed §1.199A-7(c)(3) and (d)(3).

Proposed §1.199A-7 provides rules similar to those provided in §1.199A-6. In §1.199A-6, relevant passthrough entities (RPEs) are not permitted to take the section 199A deduction but are required to determine and report the information necessary for their direct and indirect owners to determine their individual section 199A(a) deductions. Section 1.199A-6 requires RPEs to determine and report on or attach to the RPEs' Schedule K-1s to the Form 1065 for each trade or business in which the RPE was directly engaged four items: (1) The amount of QBI, (2) W-2 wages, (3) UBIA of qualified property, and (4) SSTBs.

Although Cooperatives are not RPEs, Cooperatives make distributions to patrons that such patrons are permitted to include in calculating their individual section 199A(a) deductions. Proposed §1.199A-7(c) and (d) require the Cooperatives to determine and report to their patrons whether the distributions for which the Cooperatives take deductions under section 1382(b) and/or (c)(2), as applicable, constitute qualified items of income, gain, deduction, and loss and whether they are from an SSTB in which the Cooperative was directly engaged.

In TD 9847 the Treasury Department and the IRS determined that the reporting burden in §1.199A-6 was estimated at 30 minutes to 20 hours, depending on individual circumstances, with an estimated average of 2.5 hours for all affected entities, regardless of size. The burden on entities with business receipts below $10 million was expected to be at the lower end of the range (30 minutes to 2.5 hours). The estimated compliance burden for passthrough entities that issue Schedules K-1 is $53 per hour. This estimate was derived from the Business Taxpayer Burden model developed by the IRS's Office of Research, Applied Analytics, and Statistics (RAAS), which relates time and out-of-pocket costs of business tax preparation, derived from survey data, to assets and receipts of affected taxpayers along with other relevant variables. See Tax Compliance Burden (John Guyton et al., July 2018) at https://www.irs.gov/pub/irs-soi/d13315.pdf. Thus, the annual aggregate burden on businesses with gross receipts below $10 million was estimated to be between $19.50 and $132.50 per business. The Treasury Department and the IRS determined in TD 9847 that the requirements in §1.199A-6 imposed no significant economic impact on affected entities.

The reporting requirements under proposed §1.199A-7(c)(3) and (d)(3) require Specified Cooperatives to report only two of the four pieces of information RPEs are required to report under proposed §1.199A-6: the amount of qualified items of income, gain, deduction, and loss and whether the distributions are from an SSTB in which the Cooperative was directly engaged.

The burden imposed by proposed §1.199A-7(c)(3) and (d)(3) only occurs when a Cooperative has net income that it may distribute to its patrons such that the income will qualify for the income tax deductions under section 1382(b) and/or (c), as applicable. With respect to this net income, Cooperatives already know the source of their income and deductions without which information they would not be able to determine the correct distributions to their patrons and to claim the income tax deduction for these distributions under section 1382(b) and/or (c)(2), as applicable. Finally, assuming that the approximately 4,050 filers of Forms 1120-C that reported annual gross receipts of less than $750,000 in 2017 and that each business incurred half of the higher figure of $132.50 ($66.25) determined for the §1.199A-6 regulations to satisfy the reporting requirements under proposed §1.199A-7(c)(3) and (d)(3), the annual burden imposed by the reporting requirements would not exceed $66.25 per business. Accordingly, the Treasury Department and the IRS conclude that the requirements in proposed §1.199A-7(c)(3) and (d)(3) will not impose a significant economic impact on small entities.

B. Proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3)

Although proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) will have an impact on a substantial number of small entities, this economic impact will not be significant. As previously noted, in 2017, approximately 45 percent of Cooperatives reported on Forms 1120-C gross receipts of less than $750,000. Therefore, a substantial number of small entities are affected by proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3).

Proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) requires Cooperatives to notify patrons if, pursuant to the transition rule in section 101 of the 2018 Act, the patron is barred from using certain qualified payments from a Cooperative to claim a section 199A(a) deduction in a taxable year because these qualified payments are attributable to QPAI with respect to which a deduction is allowable to the Cooperative under former section 199 in a taxable year beginning before January 1, 2018. The Cooperative knows which patrons are impacted since, in order to claim its deduction under former section 199, the Cooperative must identify which qualified payments to use. The Treasury Department and the IRS estimate that the annual burden imposed by the requirement in proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) will be far less than the $66.25 per business estimated for the requirements in proposed §§1.199A-7(c)(3) and 1.199A-8(c)(3) discussed above, since the Cooperatives know which patrons are impacted and the reporting is limited to informing these patrons that they cannot use such qualified payments to calculate their section 199A(a) deduction.

In addition, absent notice from the Cooperatives, patrons would have no way of determining whether they were barred from claiming the section 199A(a) deduction using such qualified payments. Finally, Cooperatives are not able to claim a deduction under former section 199 for taxable years beginning after December 31, 2017. Therefore, the reporting required by proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) will be for a short duration and have a limited impact on Cooperatives. Accordingly, for all these reasons, the requirements in proposed §§1.199A-7(h)(3) and 1.199A-8(h)(3) will not impose a significant economic impact on small entities.

C. Proposed §§1.199A-7(f)(3) and 1.199A-8(d)(3)

Sections 1.199A-7(f)(3) and 1.199A-8(d)(3) will not have a significant economic impact on a substantial number of small entities. This claim is based on the fact that this rulemaking will impact a population of Specified Cooperatives, only a small percentage of which are considered small entities. According to the Business Master File filing data from the transcribed fields from the Forms 1120-C for 2017, of the approximately 9,000 Forms 1120-C filed by Cooperatives, approximately 2,000 filers identified their Cooperatives as involving agriculture or horticulture using the NAICS. As noted previously, a Cooperative is considered small if it reports less than $750,000 in annual gross receipts. Of the 2,000 filers of Forms 1120-C identifying as Specified Cooperatives, only 175 filers (less than 1 percent) reported annual gross receipts of less than $750,000. Accordingly, proposed §§1.199A-7(f)(3) and 1.199A-8(d)(3) will not impose a significant economic impact on a substantial number of small entities.

D. Proposed §1.199A-8(f)

Although proposed §1.199A-8(f) will have an impact on a substantial number of small entities, this impact will not be economically significant. According to the Business Master File filing data from the transcribed fields from the Forms 1065 for 2017, the IRS estimates that there were 3,954,000 partnerships reporting their partners' share of partnership items on Schedules K-1 (Form 1065). The IRS also identified approximately 407 different partnerships that issued a Schedule K-1 to 680 different Cooperatives in 2017. The IRS does not have information as to whether the 680 Cooperatives all qualified as Specified Cooperatives.

Of the 407 different partnerships, the IRS determined that 344 of the partnerships conducted activities in 2017 that would have required the partnerships to file under proposed §1.199A-8(f). The IRS does not have sufficient data to determine the type of business activities of the remaining 63 partnerships. To be as comprehensive and transparent as possible in analyzing the potential impact of the proposed regulations, it is assumed that all 63 of these partnerships would be required to file under proposed §1.199A-8(f) and would be considered small entities.

Of the 344 partnerships identified as having both issued a Schedule K-1 to a Cooperative and conducting eligible activities in 2017, the IRS determined that 158 of these partnerships conducted activities for which the Small Business Administration (SBA) uses the number of employees to determine if an entity is a small entity using the NAICS. The IRS determined that 153 of these 158 partnerships would be small entities, while five would not be small entities based on the reported number of Forms W-2 filed in connection with the Forms 1065 the partnerships filed in 2017.

The SBA uses income to determine if an entity is a small entity for the reported business activities of the remaining 186 partnerships using the NAICS. Based upon the reported income for 2017, 140 of the remaining 186 partnerships are small entities, while 46 partnerships are not small entities. Therefore, a substantial number of small entities are affected by requirements in proposed §1.199A-8(f).

The economic impact of proposed §1.199A-8(f), however, will not be significant because the information required to be reported is gross receipts and related deductions. This information is readily available to each partnership and already known for the purpose of determining tax obligations. Because the information required to be reported is already available and familiar to each partnership, the reporting required by proposed §1.199A-8(f) will not impose a significant economic impact on small entities.

Accordingly, the Treasury Department and the IRS hereby certify that the proposed regulations will not have a significant economic impact on a substantial number of small entities. We invite public comments with respect to this conclusion.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (titled Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications, and does not impose substantial direct compliance costs on state and local governments or preempt state law, within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

The Treasury Department and the IRS request comments on all aspects of the proposed rules. Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the *Federal Register*.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, Notices and other guidance cited in this document are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

Drafting Information

The principal author of these proposed regulations is Theresa Melchiorre, Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-136459-09) published in the *Federal Register* (80 FR 51978) on August 27, 2015, is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 is proposed to be amended as follows:

PART 1 – INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by:

1. Removing the entries for §§ 1.199-0 through 1.199-9, and

2. Adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805

* * * * *

Section 1.199A-7 also issued under 26 U.S.C. 199A(f)(4) and (g)(6).

Section 1.199A-8 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-9 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-10 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-11 also issued under 26 U.S.C. 199A(g)(6).

Section 1.199A-12 also issued under 26 U.S.C. 199A(g)(6).

* * * * *

§§1.199-0 through 1.199-9 [Removed]

Par. 2. Sections 1.199-0 through 1.199-9 are removed.

Par. 3. Sections 1.199A-7 through 1.199A-12 are added to read as follows:

Sec.

* * * * *

1.199A-7 Section 199A(a) Rules for Cooperatives and their Patrons.

1.199A-8 Deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives.

1.199A-9 Domestic production gross receipts.

1.199A-10 Allocation of costs of goods sold (COGS) and other deductions to domestic production gross receipts (DPGR), and other rules.

1.199A-11 Wage limitation for the section 199A(g) deduction.

1.199A-12 Expanded affiliated groups.

* * * * *

§1.199A-7 Section 199A(a) Rules for Cooperatives and their Patrons.

(a) Overview--(1) In general. This section provides guidance and special rules on the application of the rules of §§1.199A-1 through 1.199A-6 regarding the deduction for qualified business income (QBI) under section 199A(a) (section 199A(a) deduction) of the Internal Revenue Code (Code) by patrons (patrons) of cooperatives to which Part I of subchapter T of chapter 1 of subtitle A of the Code applies (Cooperatives). Unless otherwise provided in this section, all of the rules in §§1.199A-1 through 1.199A-6 relating to calculating the section 199A(a) deduction apply to patrons and Cooperatives. Paragraph (b) of this section provides special rules for patrons relating to trades or businesses. Paragraph (c) of this section provides special rules for patrons and Cooperatives relating to the definition of QBI. Paragraph (d) of this section provides special rules for patrons and Cooperatives relating to specified service trades or businesses (SSTBs). Paragraph (e) of this section provides special rules for patrons relating to the statutory limitations based on W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property. Paragraph (f) of this section provides special rules for specified agricultural or horticultural cooperatives (Specified Cooperatives) and paragraph (g) of this section provides examples for Specified Cooperatives and their patrons. Paragraph (h) of this section sets forth the applicability date of this section and a special transition rule relating to Specified Cooperatives and their patrons.

(2) At patron level. The section 199A(a) deduction is applied at the patron level, and patrons who are individuals (as defined in §1.199A-1(a)(2)) may take the section 199A(a) deduction.

(3) Definitions. For purposes of section 199A and §1.199A-7, the following definitions apply--

(i) Individual is defined in §1.199A-1(a)(2).

(ii) Patron is defined in §1.1388-1(e).

(iii) Patronage and nonpatronage is defined in §1.1388-1(f).

(iv) Relevant Passthrough Entity (RPE) is defined in §1.199A-1(a)(9).

(v) Qualified payment is defined in §1.199A-8(d)(2)(ii).

(vi) Specified Cooperative is defined in §1.199A-8(a)(2) and is a subset of Cooperatives defined in §1.199A-7(a)(1).

(b) Trade or business. A patron (whether the patron is an RPE or an individual) must determine whether it has one or more trades or businesses that it directly conducts as defined in §1.199A-1(b)(14). To the extent a patron operating a trade or business has income directly from that business, the patron must follow the rules of §§1.199A-1 through 1.199A-6 to calculate the section 199A deduction. Patronage dividends or similar payments are considered to be generated from the trade or business the Cooperative conducts on behalf of or with the patron, and are tested by the Cooperative at its trade or business level. A patron that receives patronage dividends or similar payments, as described in paragraph (c)(1) of this section, from a

Cooperative must follow the rules of paragraphs (c) through (e) of this section to calculate the section 199A deduction.

(c) Qualified Business Income--(1) In general. QBI means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of §1.199A-3(b). A qualified item of income includes distributions for which the Cooperative is allowed a deduction under section 1382(b) and (c)(2) (including patronage dividends or similar payments, such as money, property, qualified written notices of allocations, and qualified per-unit retain certificates, as well as money or property paid in redemption of a nonqualified written notice of allocation (collectively patronage dividends or similar payments)), provided such distribution is otherwise a qualified item of income, gain, deduction, or loss. See special rule in paragraph (d)(3) of this section relating to SSTBs that may affect QBI.

(2) QBI determinations made by patron. A patron must determine QBI for each trade or business it directly conducts. In situations where the patron receives distributions described in paragraph (c)(1) of this section, the Cooperative must determine whether those distributions include qualified items of income, gain, deduction, and loss. These distributions may be included in the QBI of the patron's trade or business:

(i) To the extent that those payments are related to the patron's trade or business;

(ii) Are qualified items of income, gain, deduction, and loss at the Cooperative's trade or business level;

(iii) Are not income from an SSTB at the Cooperative's trade or business level (except as permitted by the threshold rules (see §1.199A-5(a)(2)); and

(iv) Provided the patron receives certain information from the Cooperative about these payments as provided in paragraphs (c)(3) and (d)(3) of this section.

(3) Qualified items of income, gain, deduction, and loss determinations made and reported by Cooperatives. In the case of a Cooperative that makes distributions described in paragraph (c)(1) of this section to a patron, the Cooperative must determine the amount of qualified items of income, gain, deduction, and loss in those distributions. Pursuant to this paragraph (c)(3), the Cooperative must report the amounts of qualified items with respect to any non-SSTB of the Cooperative in the distributions made to the patron on an attachment to or on the Form 1099-PATR, Taxable Distributions Received From Cooperatives (Form 1099-PATR), (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report on or before the due date of the Form 1099-PATR the amount of such qualified items of income, gain, deduction, and loss in the distributions to the patron, the amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero. See special rule in paragraph (d)(3) of this section relating to reporting of qualified items of income, gain, deduction, and loss with respect to SSTBs of the Cooperative.

(d) Specified Service Trades or Businesses--(1) In general. This section provides guidance on the determination of SSTBs. Unless otherwise provided in this section, all of the rules in §1.199A-5 relating to SSTBs apply to patrons of Cooperatives.

(2) SSTB determinations made by patron. A patron (whether an RPE or an individual) must determine whether each trade or business it directly conducts is an SSTB.

(3) SSTB determinations made and reported by Cooperatives. In the case of a Cooperative that makes distributions described in paragraph (c)(1) of this section to a patron, the Cooperative must determine whether the distributions from the Cooperative include items of income, gain, deduction, and loss from an SSTB directly conducted by the Cooperative, and whether such items are qualified items of income, gain, deduction, and loss with respect to such SSTB. The Cooperative must report to the patron the amount of income, gain, deduction, and loss in the distributions that is a qualified item of income, gain, deduction, and loss with respect to such SSTB. The Cooperative must report the amount on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report the amount on or before the due date of the Form 1099-PATR, then only the amount that a Cooperative reports as qualified items of income, gain, deduction, and loss under §1.199A-7(c)(3) may be included in the patron's QBI, and the remaining amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero.

(e) W-2 wages and unadjusted basis immediately after acquisition of qualified property—(1) In general. This section provides guidance on calculating a trade or business's W-2 wages and the UBIA of qualified property properly allocable to QBI.

(2) Determinations made by patron. The determination of W-2 wages and UBIA of qualified property must be made for each trade or business by the patron (whether an

RPE or individual) that directly conducts the trade or business before applying the aggregation rules of §1.199A-4. Unlike RPEs, Cooperatives do not allocate their W-2 wages and UBIA of qualified property to patrons.

(f) Special rules for patrons of Specified Cooperatives--(1) Section 199A(b)(7) reduction. A patron of a Specified Cooperative that receives a qualified payment must reduce its section 199A(a) deduction as provided in §1.199A-1(e)(7). This reduction applies whether the Specified Cooperative passes through all, some, or none of the Specified Cooperative's section 199A(g) deduction to the patron in that taxable year. The proposed rules relating to the section 199A(g) deduction can be found in §§1.199A-8 through 1.199A-12.

(2) Deduction Calculation--(i) Allocation method. If in any taxable year, a patron receives both qualified payments and income that is not a qualified payment in a trade or business, the patron must allocate those items and related deductions using a reasonable method based on all the facts and circumstances. Different reasonable methods may be used for different items and related deductions of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year of the patron to another, and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all the facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations under this paragraph (f)(2)(i).

(ii) Safe harbor. A patron with taxable income under the threshold amount set forth in section 199A(e)(2) is eligible to use the safe harbor set forth in this paragraph (f)(2)(ii) instead of the allocation method set forth in paragraph (f)(2)(i) of this section for any taxable year in which the patron receives qualified payments and income from other than qualified payments in its trade or business. Under the safe harbor the patron may apportion its deductions and W-2 wages ratably between income from qualified payments and income from other than qualified payments for purposes of calculating the reduction in paragraph (f)(1) of this section. Accordingly, the amount of deductions apportioned to determine QBI allocable to qualified payments is equal to the proportion of the total deductions that the amount of qualified payments bears to total gross receipts used to determine QBI. The same proportion applies to determine the amount of W-2 wages allocable to the portion of the trade or business that received qualified payments.

(3) Qualified payments notice requirement. A Specified Cooperative must report the amount of the qualified payments made to the eligible taxpayer, as defined in section 199A(g)(2)(D), on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

(g) Examples. The following examples illustrate the provisions of paragraph (f) of this section. For purposes of these examples, assume that the Specified Cooperative has satisfied the applicable written notice requirements in paragraphs (c)(3), (d)(3) and (f)(3) of this section.

(1) Example 1. Patron of Specified Cooperative with W-2 wages. (i) P, a grain farmer and patron of nonexempt Specified Cooperative (C), delivered to C during 2018 2% of all grain marketed through C during such year. During 2019, P receives $20,000 in patronage dividends and $1,000 of allocated section 199A(g) deduction from C related to the grain delivered to C during 2018.

(ii) P has taxable income of $75,000 for 2019 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to its grain trade or business for 2019 is $50,000, which consists of gross receipts of $150,000 from sales to an independent grain elevator, per-unit retain allocations received from C during 2019 of $80,000, patronage dividends received from C during 2019 related to C's 2018 net earnings of $20,000, and expenses of $200,000 (including $50,000 of W-2 wages).

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C during 2019 is $10,000, which consists of per-unit retain allocations received from C during 2019 of $80,000, patronage dividends received from C during 2019 related to C's 2018 net earnings of $20,000, and properly allocable expenses of $90,000 (including $25,000 of W-2 wages).

(iv) P's deductible amount related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($900) or 50% of W-2 wages related to qualified payments received from C ($12,500), or $9,100. As P does not have any other trades or businesses, the combined QBI amount is also $9,100.

(v) P's deduction under section 199A for 2019 is $10,100, which consists of the combined QBI amount of $9,100, plus P's deduction passed through from C of $1,000.

(2) Example 2. Patron of Specified Cooperative without W-2 wages. (i) C and P have the same facts for 2018 and 2019 as Example 1, except that P has expenses of $200,000 that include zero W-2 wages during 2019.

(ii) P's deductible amount related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($900) or 50% of W-2 wages related to qualified payments received from C ($0), or $10,000.

(iii) P's deduction under section 199A for 2019 is $11,000, which consists of the combined QBI amount of $10,000, plus P's deduction passed through from C of $1,000.

(3) Example 3. Patron of Specified Cooperative – Qualified Payments do not equal QBI and no section 199A(g) passthrough. (i) P, a grain farmer and a patron of a nonexempt Specified Cooperative (C), during 2019, receives $60,000 in patronage dividends, $100,000 in per-unit retain allocations, and $0 of allocated section 199A(g) deduction from C related to the grain delivered to C. C notifies P that only $150,000 of the patronage dividends and per-unit retain allocations are qualified payments because $10,000 of the payments are not attributable to C's qualified production activities income (QPAI).

(ii) P has taxable income of $90,000 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to its grain trade or business is $45,000, which consists of gross receipts of $95,000 from sales to an independent grain elevator, plus $160,000 from C (all payments from C qualify as qualified items of income, gain, deduction, and loss), less expenses of $210,000 (including $30,000 of W-2 wages).

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C is $25,000, which consists of the qualified payments received from C of $150,000, less the properly allocable expenses of $125,000 (including $18,000 of W-2 wages), which were determined using a reasonable method under paragraph (f)(2)(ii) of this section.

(iv) P's patron reduction is $2,250, which is the lesser of 9% of QBI related to qualified payments received from C, $2,250 (9% x $25,000), or 50% of W-2 wages related to qualified payments received from C, $9,000 (50% x $18,000). As P does not have any other trades or businesses, the combined QBI amount is $6,750 (20% of P's total QBI, $9,000 (20% x $45,000), reduced by the patron reduction of $2,250).

(v) P's deduction under section 199A is $6,750, which consists of the combined QBI amount of $6,750.

(4) Example 4. Patron of Specified Cooperative – Reasonable Method under paragraph (f)(2)(ii) of this section. P is a grain farmer that has $45,000 of QBI related to P's grain trade or business in 2019. P's QBI consists of $105,000 of sales to an independent grain elevator, $100,000 of per-unit retain allocations, and $50,000 of patronage dividends from a nonexempt Specified Cooperative (C), for which C reports $150,000 of qualified payments to P as required by paragraph (f)(3) of this section. P's grain trade or business has $210,000 of expenses (including $30,000 of W-2 wages). P delivered 65x bushels of grain to C and sold 35x bushels of comparable grain to the independent grain elevator. To allocate the expenses between qualified payments ($150,000) and other income ($105,000), P compares the bushels of grain delivered to C (65x) to the total bushels of grain delivered to C and sold to the independent grain elevator (100x). P determines $136,500 (65% x $210,000) of expenses (including $19,500 of W-2 wages) are properly allocable to the qualified payments. The portion of QBI from P's grain trade or business related to qualified payments received from C is $13,500, which consists of qualified payments of $150,000 less the properly allocable expenses of $136,500 (including $19,500 of W-2 wages). P's method of allocating expenses is a reasonable method under paragraph (f)(2)(ii) of this section.

(5) Example 5. Patron of Specified Cooperative using safe harbor to allocate. (i) P is a grain farmer with taxable income of $100,000 for 2019 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to P's grain trade or business for 2019 is $50,000, which consists of gross receipts of $180,000 from sales to an independent grain elevator, per-unit retain allocations received from a Specified Cooperative (C) during 2019 of $15,000, patronage dividends received from C during 2019 related to C's 2018 net earnings of $5,000, and expenses of $150,000 (including $50,000 of W-2 wages). C also passed through $1,800 of the section 199A(g) deduction to P, which related to the grain delivered by P to the Specified Cooperative during 2018. P uses the safe harbor in paragraph (f)(2)(iii) of this

section to determine the expenses (including W-2 wages) allocable to the qualified payments.

(ii) Using the safe harbor to allocate P's $150,000 of expenses, P allocates $15,000 of the expenses to the qualified payments ($150,000 of expenses multiplied by the ratio (0.10) of qualified payments ($20,000) to total gross receipts ($200,000)). Using the same ratio, P also determines there are $5,000 of W-2 wages allocable ($50,000 multiplied by 0.10) to the qualified payments.

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C during 2019 is $5,000, which consists of per-unit retain allocations received from C during 2019 of $15,000, patronage dividends of $5,000, and properly allocable expenses of $15,000 (including $5,000 of W-2 wages).

(iv) P's QBI related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($450) or 50% of W-2 wages related to qualified payments received from C ($2,500), or $9,550. As P does not have any other trades or businesses, the combined QBI amount is also $9,550.

(v) P's deduction under section 199A for 2019 is $11,350, which consists of the combined QBI amount of $9,550, plus P's deduction passed through from C of $1,800.

(h) Effective/applicability date--(1) General rule. Except as provided in paragraph (h)(2) of this section, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

(2) Transition rule for qualified payments of patrons of Cooperatives. No deductions under section 199A are allowed to patrons for any qualified payments that are attributable to QPAI with respect to which a deduction is allowable to the Specified Cooperative under section 199 as in effect on and before December 31, 2017, for a taxable year of the Specified Cooperative beginning before January 1, 2018.

(3) Notice from the Cooperative. If a patron of a Cooperative cannot claim a deduction under section 199A for any qualified payments described in the transition rule set forth in paragraph (h)(2) of this section, the Cooperative must report this information on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

§1.199A-8 Deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives.

(a) Overview--(1) In general. This section provides rules relating to the deduction for income attributable to domestic production activities of a specified agricultural or horticultural cooperative (Specified Cooperative). This paragraph (a) provides an overview and definitions of certain terms. Paragraph (b) of this section provides rules explaining the steps a nonexempt Specified Cooperative performs to calculate its section 199A(g) deduction and includes definitions of relevant terms. Paragraph (c) of this section provides rules explaining the steps an exempt Specified Cooperative performs to calculate its section 199A(g) deduction. Paragraph (d) of this section provides rules for Specified Cooperatives passing through the section 199A(g) deduction to patrons. Paragraph (e) of this section provides examples that illustrate the provisions of paragraphs (b), (c), and (d) of this section. Paragraph (f) of this section provides guidance for Specified Cooperatives that are partners in a partnership. Paragraph (g) of this section provides guidance on the recapture of a claimed section 199A(g) deduction. Paragraph (h) of this section provides effective dates. For additional rules addressing an expanded affiliated group (EAG) see §1.199A-12. The principles of this section apply to the EAG rules in §1.199A-12.

(2) Specified Cooperative--(i) In general. Specified Cooperative means a cooperative to which Part I of subchapter T of chapter 1 of subtitle A of the Internal Revenue Code (Code) applies and which--

(A) Manufactures, produces, grows, or extracts (MPGE) in whole or significant part within the United States any agricultural or horticultural product, or

(B) Is engaged in the marketing of agricultural or horticultural products that have been MPGE in whole or significant part within the United States by the patrons of the cooperative.

(ii) Additional rules. See §1.199A-9 for rules to determine if a Specified Cooperative has MPGE an agricultural or horticultural product in whole or significant part within the United States.

(iii) Types of Specified Cooperatives. A Specified Cooperative that is qualified as a farmer's cooperative organization under section 521 is an exempt Specified Cooperative, while a Specified Cooperative not so qualified is a nonexempt Specified Cooperative.

(3) Patron is defined in §1.1388-1(e).

(4) Agricultural or horticultural products are agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926, 44 Stat. 802 (1926). Agricultural or horticultural

products also include aquatic products that are farmed whether by an exempt or a nonexempt Specified Cooperative. In addition, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are MPGE by a Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property (other than as provided in the exception in §1.199A-9(b)(2)); for example, an agricultural or horticultural product includes a seed that is grown, but does not include the intangible property right to reproduce a seed for sale. This exclusion of intangible property does not apply to intangible characteristics of any particular agricultural or horticultural product. For example, gross receipts from the sale of different varieties of oranges would all qualify as DPGR from the disposition of agricultural or horticultural products (assuming all other requirements of section 199A(g) are met). However, gross receipts from the license of the right to produce and sell a certain variety of an orange would be considered separate from the orange and not from an agricultural or horticultural product.

(b) <u>Steps for a nonexempt Specified Cooperative in calculating deduction</u>--(1) <u>In general</u>. Except as provided in paragraph (c)(3) of this section, this paragraph (b) applies only to nonexempt Specified Cooperatives.

(2) <u>Step 1 - Gross receipts and related deductions</u>--(i) <u>Identify</u>. To determine the section 199A(g) deduction, a Specified Cooperative first identifies its patronage and nonpatronage gross receipts and related cost of goods sold (COGS), deductible expenses, W-2 wages, etc. (deductions) and allocates them between patronage and nonpatronage. A single definition for the term <u>patronage and nonpatronage</u> is found in §1.1388-1(f).

(ii) Applicable gross receipts and deductions. For all purposes of the section 199A(g) deduction, a Specified Cooperative can use only patronage gross receipts and related deductions to calculate qualified production activities income (QPAI) as defined in paragraph (b)(4)(ii) of this section, oil-related QPAI as defined in paragraph (b)(7)(ii) of this section, or the W-2 wage limitation in paragraph (b)(5)(ii)(B) of this section. A Specified Cooperative cannot use its nonpatronage gross receipts and related deductions to calculate its section 199A(g) deduction.

(iii) Gross receipts are the Specified Cooperative's receipts for the taxable year that are recognized under the Specified Cooperative's methods of accounting used for Federal income tax purposes for the taxable year. See §1.199A-12 if the gross receipts are recognized in an intercompany transaction within the meaning of §1.1502-13. Gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (except interest under section 103 but including original issue discount), dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the Specified Cooperative's trade or business. Gross receipts are not reduced by COGS or by the cost of property sold if such property is described in section 1221(a)(1), (2), (3), (4), or (5). Finally, gross receipts do not include amounts received by the Specified Cooperative with respect to sales tax or other similar state or local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the Specified Cooperative merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the Specified

Cooperative under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(3) Step 2 – Determine gross receipts that are DPGR--(i) In general. A Specified Cooperative examines its patronage gross receipts to determine which of these are DPGR. A Specified Cooperative does not use nonpatronage gross receipts to determine DPGR.

(ii) DPGR are the gross receipts of the Specified Cooperative that are derived from any lease, rental, license, sale, exchange, or other disposition of an agricultural or horticultural product that is MPGE by the Specified Cooperative or its patrons in whole or significant part within the United States. DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. See §1.199A-9 for additional rules on determining if gross receipts are DPGR.

(4) Step 3 – Determine QPAI--(i) In general. A Specified Cooperative determines QPAI from patronage DPGR and patronage deductions identified in paragraphs (b)(3)(ii) and (b)(2)(i) of this section, respectively. A Specified Cooperative does not use nonpatronage gross receipts or deductions to determine QPAI.

(ii) QPAI for the taxable year means an amount equal to the excess (if any) of--

(A) DPGR for the taxable year, over

(B) The sum of--

(1) COGS that are allocable to DPGR, and

(2) Other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to DPGR.

(C) QPAI computational rules. QPAI is computed without taking into account the section 199A(g) deduction or any deduction allowed under section 1382(b). See §1.199A-10 for additional rules on calculating QPAI.

(5) Step 4 – Calculate deduction--(i) In general. From QPAI and taxable income, a Specified Cooperative calculates its section 199A(g) deduction as provided in paragraph (b)(5)(ii) of this section.

(ii) Deduction--(A) In general. A Specified Cooperative is allowed a deduction equal to 9 percent of the lesser of--

(1) QPAI of the Specified Cooperative for the taxable year, or

(2) Taxable income of the Specified Cooperative for the taxable year.

(B) W-2 wage limitation. The deduction allowed under paragraph (b)(5)(ii)(A) of this section for any taxable year cannot exceed 50 percent of the patronage W-2 wages attributable to DPGR for the taxable year. See §1.199A-11 for additional rules on calculating the patronage W-2 wage limitation.

(C) Taxable income. Taxable income is defined in section 1382 and §1.1382-1 and §1.1382-2. For purposes of determining the amount of the deduction allowed under paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from patronage sources. Patronage net operating losses (NOLs) reduce taxable income. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(b). Taxable income is determined using the same method of accounting used to determine distributions under section 1382(b) and qualified payments to eligible taxpayers.

(6) Use of patronage section 199A(g) deduction. Except as provided in §1.199A-12(c)(2) related to the rules for EAGs, the patronage section 199A(g) deduction cannot create or increase a patronage or nonpatronage NOL or the amount of a patronage or nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172. A patronage section 199A(g) deduction can be applied only against patronage income and deductions. A patronage section 199A(g) deduction that is not used in the appropriate taxable year is lost.

(7) Special rules for nonexempt Specified Cooperatives that have oil-related QPAI--(i) Reduction of section 199A(g) deduction. If a Specified Cooperative has oil-related QPAI for any taxable year, the amount otherwise allowable as a deduction under paragraph (b)(5)(ii) of this section must be reduced by 3 percent of the least of--

(A) Oil-related QPAI of the Specified Cooperative for the taxable year,

(B) QPAI of the Specified Cooperative for the taxable year, or

(C) Taxable income of the Specified Cooperative for the taxable year.

(ii) Oil-related QPAI means, for any taxable year, the patronage QPAI that is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (within the meaning of section 927(a)(2)(C), as in effect before its repeal) during such taxable year. Oil-related QPAI for any taxable year is an amount equal to the excess (if any) of patronage DPGR derived from the production, refining or processing of oil, gas, or any primary product thereof (oil-related DPGR) over the sum of--

(A) COGS of the Specified Cooperative that is allocable to such receipts; and

(B) Other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to such receipts.

(iii) Special rule for patronage oil-related DPGR. Oil-related DPGR does not include gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof. However, to the extent that the nonexempt Specified Cooperative treats gross receipts derived from transportation or distribution of oil, gas, or any primary product thereof as part of DPGR under §1.199A-9(j)(3)(i), or under §1.199A-9(j)(3)(i)(B), then the Specified Cooperative must treat those patronage gross receipts as oil-related DGPR.

(iv) Oil includes oil recovered from both conventional and non-conventional recovery methods, including crude oil, shale oil, and oil recovered from tar/oil sands. The primary product from oil includes all products derived from the destructive distillation of oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil. The primary product from gas means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline. The primary products from oil and gas provided in this paragraph (b)(7)(iv) are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies. Examples of non-primary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.

(c) Exempt Specified Cooperatives--(1) In general. This paragraph (c) applies only to exempt Specified Cooperatives.

(2) Two section 199A(g) deductions. The Specified Cooperative must calculate two separate section 199A(g) deductions, one patronage sourced and the other nonpatronage sourced. Patronage and nonpatronage gross receipts, related COGS that are allocable to DPGR, and other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to DPGR (deductions), DPGR, QPAI, NOLs, W-2 wages, etc. are not netted to calculate these two separate section 199A(g) deductions.

(3) Exempt Specified Cooperative patronage section 199A(g) deduction. The Specified Cooperative calculates its patronage section 199A(g) deduction following steps 1 through 4 in paragraphs (b)(2) through (5) of this section as if it were a nonexempt Specified Cooperative.

(4) Exempt Specified Cooperative nonpatronage section 199A(g) deduction--(i) In general. The Specified Cooperative calculates its nonpatronage section 199A(g) deduction following steps 2 through 4 in paragraphs (b)(2) through (5) of this section using only nonpatronage gross receipts and related nonpatronage deductions. For purposes of determining the amount of the nonpatronage section 199A(g) deduction allowed under paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from nonpatronage sources. Nonpatronage NOLs reduce taxable income. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(c). Taxable

income is determined using the same method of accounting used to determine distributions under section 1382(c)(2).

(ii) Use of nonpatronage section 199A(g) deduction. Except as provided in §1.199A-12(c)(2) related to the rules for EAGs, the nonpatronage section 199A(g) deduction cannot create or increase a nonpatronage NOL or the amount of nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172. A Specified Cooperative cannot allocate its nonpatronage section 199A(g) deduction under paragraph (d) of this section and can apply the nonpatronage section 199A(g) deduction only against its nonpatronage income and deductions. As is the case for the patronage section 199A(g) deduction, the nonpatronage section 199A(g) deduction that a Specified Cooperative does not use in the appropriate taxable year is lost.

(d) Discretion to pass through deduction--(1) In general. A Specified Cooperative may, at its discretion, pass through all, some, or none of its patronage section 199A(g) deduction to an eligible taxpayer. An eligible taxpayer is a patron other than a C corporation or a Specified Cooperative. A Specified Cooperative member of a federated cooperative may pass through the patronage section 199A(g) deduction it receives from the federated cooperative to its member patrons that are eligible taxpayers.

(2) Amount of deduction being passed through--(i) In general. A Specified Cooperative is permitted to pass through to an eligible taxpayer an amount equal to the portion of the Specified Cooperative's section 199A(g) deduction that is allowed with respect to the portion of the cooperative's QPAI that is attributable to the qualified

payments the Specified Cooperative distributed to the eligible taxpayer during the taxable year and identified on the notice required in §1.199A-7(f)(3) on an attachment to or on the Form 1099-PATR, Taxable Distributions Received From Cooperatives (Form 1099-PATR), (or any successor form) issued by the Specified Cooperative to the eligible taxpayer, unless otherwise provided by the instructions to the Form. The notice requirement to pass through the section 199A(g) deduction is in paragraph (d)(3) of this section.

(ii) Qualified payment means any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) received by a patron from a Specified Cooperative that is attributable to the portion of the Specified Cooperative's QPAI, for which the cooperative is allowed a section 199A(g) deduction. For this purpose, patronage dividends include any advances on patronage and per-unit retain allocations include per-unit retains paid in money during the taxable year. A Specified Cooperative calculates its qualified payment using the same method of accounting it uses to calculate its taxable income.

(3) Notice requirement to pass through deduction. A Specified Cooperative must identify in a written notice the amount of the section 199A(g) deduction being passed through to the eligible taxpayer. This written notice must be mailed by the Specified Cooperative to the eligible taxpayer no later than the 15th day of the ninth month following the close of the taxable year of the Specified Cooperative. The Specified Cooperative may use the same written notice, if any, that it uses to notify the eligible taxpayer of the eligible taxpayer's respective allocations of patronage distributions, or may use a separate timely written notice(s) to comply with this section.

The Specified Cooperative must report the amount of section 199A(g) deduction passed through to the eligible taxpayer on an attachment to or on the Form 1099-PATR (or any successor form) issued by the Specified Cooperative to the eligible taxpayer, unless otherwise provided by the instructions to the Form.

(4) Section 199A(g) deduction allocated to eligible taxpayer. An eligible taxpayer may deduct the lesser of the section 199A(g) deduction identified on the notice described in paragraph (d)(3) of this section or the eligible taxpayer's taxable income in the taxable year in which the eligible taxpayer receives the timely written notice described in paragraph (d)(3) of this section. For this purpose, the eligible taxpayer's taxable income is determined without taking into account the section 199A(g) deduction being passed through to the eligible taxpayer and after taking into account any section 199A(a) deduction allowed to the eligible taxpayer. Any section 199A(g) deduction the eligible taxpayer does not use in the taxable year in which the eligible taxpayer receives the notice (received on or before the due date of the Form 1099-PATR) is lost and cannot be carried forward or back to other taxable years. The taxable income limitation for the section 199A(a) deduction set forth in section 199A(b)(3) and §1.199A-1(a) and (b) does not apply to limit the deductibility of the section 199A(g) deduction passed through to the eligible taxpayer.

(5) Special rules for eligible taxpayers that are Specified Cooperatives. A Specified Cooperative that receives a section 199A(g) deduction as an eligible taxpayer can take the deduction only against patronage gross income and related deductions.

(6) W-2 wage limitation. The W-2 wage limitation described in paragraph (b)(5)(ii)(B) of this section is applied at the cooperative level whether or not

the Specified Cooperative chooses to pass through some or all of the section 199A(g) deduction. Any section 199A(g) deduction that has been passed through by a Specified Cooperative to an eligible taxpayer is not subject to the W-2 wage limitation a second time at the eligible taxpayer's level.

(7) Specified Cooperative denied section 1382 deduction for portion of qualified payments. A Specified Cooperative must reduce its section 1382 deduction under section 1382(b) and/or (c), as applicable) by an amount equal to the portion of any qualified payment that is attributable to the Specified Cooperative's section 199A(g) deduction passed through to the eligible taxpayer. This means the Specified Cooperative must reduce its section 1382 deduction in an amount equal to the section 199A(g) deduction passed through to its eligible taxpayers.

(8) No double counting. A qualified payment received by a Specified Cooperative that is a patron of a Specified Cooperative is not taken into account by the patron for purposes of section 199A(g).

(e) Examples. The following examples illustrate the application of paragraphs (b), (c), and (d) of this section. Assume for each example that the Specified Cooperative sent all required notices to patrons on or before the due date of the Form 1099-PATR.

(1) Example 1. Nonexempt Specified Cooperative calculating section 199A(g) deduction. (i) C is a grain marketing nonexempt Specified Cooperative, with $5,250,000 in gross receipts during 2018 from the sale of grain grown by its patrons. C paid $4,000,000 to its patrons at the time the grain was delivered in the form of per-unit retain allocations pursuant to an agreement and another $1,000,000 in patronage dividends after the close of the 2018 taxable year. C has other expenses of $250,000 during 2018, including $100,000 of W-2 wages.

(ii) C has DPGR of $5,250,000 and QPAI as defined in §1.199A-8(b)(4)(ii) of $5,000,000 for 2018. C's section 199A(g) deduction is equal to the least of 9% of QPAI ($450,000), 9% of taxable income ($450,000), or 50% of W-2 wages ($50,000). C passes through the entire section 199A(g) deduction to its patrons. Accordingly, C reduces its $5,000,000 deduction allowable under section 1382(b) (relating to the $1,000,000 patronage dividends and $4,000,000 per-unit retain allocations) by $50,000.

(2) Example 2. Nonexempt Specified Cooperative calculating section 199A(g) deduction with purchases. Same facts as Example 1, except C purchased grain from its patrons for $4,000,000 and these purchases are not per-unit retain allocations described in section 1388(f). C allocated and reported the $1,000,000 patronage dividends to its patrons and provided notification (in accordance with the requirements of §1.199A-7(f)(3)) that only the patronage dividends are treated as qualified payments for purposes of its section 199A(g) deduction. C has QPAI and taxable income of $1,000,000 ($5,250,000 – $4,000,000 – $250,000). C's section 199A(g) deduction is the lesser of 9% of QPAI ($90,000), 9% of taxable income without taking into account any deduction under section 1382(b) ($90,000), or 50% of W-2 wages ($50,000). C passes through the entire section 199A(g) deduction to its patrons. Accordingly, C reduces its $1,000,000 deduction allowable under section 1382(b) by $50,000. Patrons do not include any of the $4,000,000 of payments when determining the reduction amount under section 199A(b)(7).

(3) Example 3. Nonexempt Specified Cooperative determines amounts included in QPAI and taxable income. (i) C, a nonexempt Specified Cooperative, offers harvesting services and markets the grain of patrons and nonpatrons. C had gross receipts from harvesting services and grain sales, and expenses related to both. All of C's harvesting services were performed for their patrons, and 75% of the grain sales were for patrons.

(ii) C identifies 75% of the gross receipts and related expenses from grain sales and 100% of the gross receipts and related expenses from the harvesting services as patronage sourced. C identifies 25% of the gross receipts and related expenses from grain sales as nonpatronage sourced.

(iii) C does not include any nonpatronage gross receipts or related expenses from grain sales in either QPAI or taxable income when calculating the section 199A(g) deduction. C's QPAI includes the patronage DPGR, less related expenses (allocable COGS, wages and other expenses). C's taxable income includes the patronage gross receipts, whether such gross receipts are DPGR or non-DPGR.

(iv) C allocates and reports patronage dividends to its harvesting patrons and grain marketing patrons. C also notifies its grain marketing patrons (in accordance with the requirements of §1.199A-7(f)(3)) that their patronage dividends are qualified payments used in C's section 199A(g) computation. The patrons must use this information for purposes of computing their section 199A(b)(7) reduction to their section 199A(a) deduction (see §1.199A-7(f)).

(4) Example 4. Nonexempt Specified Cooperative with patronage and nonpatronage gross receipts and related deductions. (i) C, a nonexempt Specified Cooperative, markets corn grown by its patrons in the United States. For the calendar

year ending December 31, 2020, C derives gross receipts from the marketing activity of $1,800. Such gross receipts qualify as DPGR. Assume C has $800 of expenses (including COGS, other expenses, and $400 of W-2 wages) properly allocable to DPGR, and a $1,000 deduction allowed under section 1382(b). C also derives gross receipts from nonpatronage sources in the amount of $500, and has nonpatronage deductions in the amount of $400 (including COGS, other expenses, and $100 of W-2 wages).

(ii) C does not include any gross receipts or deductions from nonpatronage sources when calculating the deduction under paragraph (b)(5)(ii) of this section. C's QPAI and taxable income both equal $1,000 ($1,800 – 800). C's deduction under paragraph (b)(5)(ii) of this section for the taxable year is equal to $90 (9% of $1,000), which does not exceed $200 (50% of C's W-2 wages properly allocable to DPGR). C passes through $90 of the deduction to patrons and C reduces its section 1382(b) deduction by $90.

(5) Example 5. Exempt Specified Cooperative with patronage and nonpatronage income and deductions. (i) C, an exempt Specified Cooperative, markets corn MPGE by its patrons in the United States. For the calendar year ending December 31, 2020, C derives gross receipts from the marketing activity of $1,800. For this activity assume C has $800 of expenses (including COGS, other expenses, and $400 of W-2 wages) properly allocable to DPGR, and a $1,000 deduction under section 1382(b). C also derives gross receipts from nonpatronage sources in the amount of $500. Assume the gross receipts qualify as DPGR. For this activity assume C has $400 of expenses (including COGS, other expenses, and $20 of W-2 wages) properly allocable to DPGR and no deduction under section 1382(c).

(ii) C calculates two separate section 199A(g) deduction amounts. C's section 199A(g) deduction attributable to patronage sources is the same as the deduction calculated by the nonexempt Specified Cooperative in Example 1 in paragraph (e)(1) of this section.

(iii) C's nonpatronage QPAI and taxable income is equal to $100 ($500 – $400). C's deduction under paragraph (c)(3) of this section that directs C to use paragraph (b)(5)(ii) of this section attributable to nonpatronage sources is equal to $9 (9% of $100), which does not exceed $10 (50% of C's W-2 wages properly allocable to DPGR). C cannot pass through any of the nonpatronage section 199A(g) deduction amount to its patrons.

(6) Example 6. NOL. C, a nonexempt Specified Cooperative, MPGE agricultural or horticultural products. C is not part of an EAG as defined in §1.199A-12. In 2018, C generates QPAI and taxable income is $600, without taking into account any of its deductions under section 1382(b), the deduction under section 199A(g), or an NOL deduction. During 2018, C incurs W-2 wages as defined in §1.199A-11 of $300. C has an NOL carryover to 2018 of $500. C's deduction under this section for 2018 is $9 (9% × (lesser of QPAI of $600 and taxable income of $100 ($600 taxable income –

$500 NOL)). Under these facts the wage limitation does not act to limit the deduction because the wage limitation is $150 (50% × $300).

(7) Example 7. NOL. (i) C, a nonexempt Specified Cooperative, MPGE agricultural or horticultural products. C is not part of an EAG. In 2018, C generates QPAI and taxable income of $100, without taking into account any of its deductions under section 1382(b), the deduction under section 199A(g), or an NOL deduction. C has an NOL carryover to 2018 of $500 that reduces its taxable income for 2018 to $0. C's section 199A(g) deduction for 2018 is $0 (9% × (lesser of QPAI of $100 and taxable income of $0)).

(ii) Carryover to 2019. C's taxable income for purposes of determining its NOL carryover to 2019 is $100. Accordingly, for purposes of section 199A(g), C's NOL carryover to 2019 is $400 ($500 NOL carryover to 2018 – $100 NOL used in 2018).

(f) Special rule for Specified Cooperative partners. In the case described in section 199A(g)(5)(B), where a Specified Cooperative is a partner in a partnership, the partnership must separately identify and report on the Schedule K-1 of the Form 1065, U.S. Return of Partnership Income (or any successor form) issued to the Specified Cooperative the cooperative's share of gross receipts and related deductions, unless otherwise provided by the instructions to the Form. The Specified Cooperative determines what gross receipts reported by the partnership qualify as DPGR and includes these gross receipts and related deductions to calculate one section 199A(g) deduction (in the case of a nonexempt Specified Cooperative) or two section 199A(g) deductions (in the case of an exempt Specified Cooperative) using the steps set forth in paragraphs (b) and (c) of this section.

(g) Recapture of section 199A(g) deduction. If the amount of the section 199A(g) deduction that was passed through to eligible taxpayers exceeds the amount allowable as a section 199A(g) deduction as determined on examination or reported on an amended return, then recapture of the excess will occur at the Specified

Cooperative level in the taxable year the Specified Cooperative took the excess section 199A(g) deduction.

(h) Applicability date. Except as provided in paragraph (h)(2) of §1.199A-7, the provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

§1.199A-9 Domestic production gross receipts.

(a) Domestic production gross receipts--(1) In general. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide guidance to determine what gross receipts (defined in §1.199A-8(b)(2)(iii)) are domestic production gross receipts (DPGR) (defined in §1.199A-8(b)(3)(ii)). DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. Partners, including partners in an EAG partnership described in §1.199A-12(i)(1), may not treat guaranteed payments under section 707(c) as DPGR.

(2) Application to marketing cooperatives. For purposes of determining DPGR, a Specified Cooperative (defined in §1.199A-8(a)(2)) will be treated as having manufactured, produced, grown, or extracted (MPGE) (defined in paragraph (f) of this section) in whole or significant part (defined in paragraph (h) of this section) any agricultural or horticultural product (defined in §1.199A-8(a)(4)) within the United States

(defined in paragraph (i) of this section) marketed by the Specified Cooperative which its patrons (defined in §1.1388-1(e)) have so MPGE.

(b) Related persons--(1) In general. Pursuant to 199A(g)(3)(D)(ii), DPGR does not include any gross receipts derived from agricultural or horticultural products leased, licensed, or rented by the Specified Cooperative for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either section 52(a) or (b) (without regard to section 1563(b)), or section 414(m) or (o). Any other person is an unrelated person for purposes of the section 199A(g) deduction.

(2) Exceptions. Notwithstanding paragraph (b)(1) of this section, gross receipts derived from any agricultural or horticultural product leased or rented by the Specified Cooperative to a related person may qualify as DPGR if the agricultural or horticultural product is held for sublease or rent, or is subleased or rented, by the related person to an unrelated person for the ultimate use of the unrelated person. Similarly, notwithstanding paragraph (b)(1) of this section, gross receipts derived from a license of the right to reproduce an agricultural or horticultural product to a related person for reproduction and sale, exchange, lease, or rental to an unrelated person for the ultimate use of the unrelated person are treated as gross receipts from a disposition of an agricultural or horticultural product and may qualify as DPGR.

(c) Allocating gross receipts--(1) In general. A Specified Cooperative must determine the portion of its gross receipts for the taxable year that is DPGR and the portion of its gross receipts that is non-DPGR using a reasonable method based on all the facts and circumstances. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition the gross receipts of which may constitute DPGR, whether it is a service the gross receipts of which may constitute non-DPGR, or some combination thereof. For example, if a Specified Cooperative sells an agricultural or horticultural product and, in connection with that sale, also provides services, the Specified Cooperative must allocate its gross receipts from the transaction using a reasonable method based on all the facts and circumstances that accurately identifies the gross receipts that constitute DPGR and non-DPGR in accordance with the requirements of §§1.199A-8(b) and/or (c). The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of gross receipts for the taxable year that is DPGR and the portion of gross receipts that is non-DPGR. The books and records maintained for gross receipts must be consistent with any allocations under this paragraph (c)(1).

(2) Reasonable method of allocation. If a Specified Cooperative has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts are derived from an item (and thus, are DPGR), then the Specified Cooperative must use that specific identification to determine DPGR. If the Specified Cooperative does not have information readily available to specifically identify whether gross receipts are derived from an item or cannot, without undue burden or expense, specifically identify whether gross receipts are derived from an item, then the Specified Cooperative is not required to use a method that specifically identifies whether the gross receipts are derived from an item but can use a reasonable allocation method. Factors taken into consideration in determining whether the

Specified Cooperative's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the Specified Cooperative uses the most accurate information available; the relationship between the gross receipts and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year.

(3) De minimis rules--(i) DPGR. A Specified Cooperative's applicable gross receipts as provided in §§1.199A-8(b) and/or (c) may be treated as DPGR if less than 5 percent of the Specified Cooperative's total gross receipts are non-DPGR (after application of the exceptions provided in §1.199A-9(j)(3)). If the amount of the Specified Cooperative's gross receipts that are non-DPGR equals or exceeds 5 percent of the Specified Cooperative's total gross receipts, then, except as provided in paragraph (c)(3)(ii) of this section, the Specified Cooperative is required to allocate all gross receipts between DPGR and non-DPGR in accordance with paragraph (c)(1) of this section. If a Specified Cooperative is a member of an expanded affiliated group (EAG) (defined in §1.199A-12), but is not a member of a consolidated group, then the determination of whether less than 5 percent of the Specified Cooperative's total gross receipts are non-DPGR is made at the Specified Cooperative level. If a Specified Cooperative is a member of a consolidated group, then the determination of whether less than 5 percent of the Specified Cooperative's total gross receipts are non-DPGR is made at the consolidated group level. See §1.199A-12(d).

(ii) Non-DPGR. A Specified Cooperative's applicable gross receipts as provided in §§1.199A-8(b) and/or (c) may be treated as non-DPGR if less than 5 percent of the Specified Cooperative's total gross receipts are DPGR. If a Specified Cooperative is a member of an EAG, but is not a member of a consolidated group, then the determination of whether less than 5 percent of the Specified Cooperative's total gross receipts are DPGR is made at the Specified Cooperative level. If a Specified Cooperative is a member of a consolidated group, then the determination of whether less than 5 percent of the Specified Cooperative's total gross receipts are DPGR is made at the consolidated group level.

(d) Use of historical data for multiple-year transactions. If a Specified Cooperative recognizes and reports gross receipts from upfront payments or other similar payments on a Federal income tax return for a taxable year, then the Specified Cooperative's use of historical data in making an allocation of gross receipts from the transaction between DPGR and non-DPGR may constitute a reasonable method. If a Specified Cooperative makes allocations using historical data, and subsequently updates the data, then the Specified Cooperative must use the more recent or updated data, starting in the taxable year in which the update is made.

(e) Determining DPGR item-by-item--(1) In general. For purposes of the section 199A(g) deduction, a Specified Cooperative determines, using a reasonable method based on all the facts and circumstances, whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis). The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of gross receipts that is DPGR. The books and records maintained for gross receipts must be consistent with any allocations under this paragraph (e)(1).

(i) The term item means the agricultural or horticultural product offered by the Specified Cooperative in the normal course of its trade or business for lease, rental, license, sale, exchange, or other disposition (for purposes of this paragraph (e), collectively referred to as disposition) to customers, if the gross receipts from the disposition of such product qualify as DPGR; or

(ii) If paragraph (e)(1)(i) of this section does not apply to the product, then any component of the product described in paragraph (e)(1)(i) of this section is treated as the item, provided that the gross receipts from the disposition of the product described in paragraph (e)(1)(i) of this section that are attributable to such component qualify as DPGR. Each component that meets the requirements under this paragraph (e)(1)(ii) must be treated as a separate item and a component that meets the requirements under this paragraph (e)(1)(ii) may not be combined with a component that does not meet these requirements.

(2) Special rules. (i) For purposes of paragraph (e)(1)(i) of this section, in no event may a single item consist of two or more products unless those products are offered for disposition, in the normal course of the Specified Cooperative's trade or business, as a single item (regardless of how the products are packaged).

(ii) In the case of agricultural or horticultural products customarily sold by weight or by volume, the item is determined using the most common custom of the industry (for example, barrels of oil).

(3) Exception. If the Specified Cooperative MPGE agricultural or horticultural products within the United States that it disposes of, and the Specified Cooperative leases, rents, licenses, purchases, or otherwise acquires property that contains or may contain the agricultural or horticultural products (or a portion thereof), and the Specified Cooperative cannot reasonably determine, without undue burden and expense, whether the acquired property contains any of the original agricultural or horticultural products MPGE by the Specified Cooperative, then the Specified Cooperative is not required to determine whether any portion of the acquired property qualifies as an item for purposes of paragraph (e)(1) of this section. Therefore, the gross receipts derived from the disposition of the acquired property may be treated as non-DPGR. Similarly, the preceding sentences apply if the Specified Cooperative can reasonably determine that the acquired property contains agricultural or horticultural products (or a portion thereof) MPGE by the Specified Cooperative, but cannot reasonably determine, without undue burden or expense, how much, or what type, grade, etc., of the agricultural or horticultural MPGE by the Specified Cooperative the acquired property contains.

(f) Definition of manufactured, produced, grown, or extracted (MPGE)--(1) In general. Except as provided in paragraphs (f)(2) and (3) of this section, the term MPGE includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating agricultural or horticultural products; making agricultural or horticultural products out of material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, and farming aquatic products. The term MPGE also includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural or horticultural products only if the products are consumed in connection with or incorporated into the MPGE of agricultural or horticultural products, whether or not by the Specified Cooperative. The Specified Cooperative (or the patron if section 1.199A-9(a)(2) applies) must have the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the MPGE activity occurs in order for the gross receipts derived from the MPGE of the agricultural or horticultural products to qualify as DPGR.

(2) Packaging, repackaging, or labeling. If the Specified Cooperative packages, repackages, or labels agricultural or horticultural products and engages in no other MPGE activity with respect to those agricultural or horticultural products, the packaging, repackaging, or labeling does not qualify as MPGE with respect to those agricultural or horticultural products.

(3) Installing. If a Specified Cooperative installs agricultural or horticultural products and engages in no other MPGE activity with respect to the agricultural or horticultural products, the Specified Cooperative's installing activity does not qualify as an MPGE activity. Notwithstanding paragraph (j)(3)(i)(A) of this section, if the Specified Cooperative installs agricultural or horticultural products MPGE by the Specified Cooperative and the Specified Cooperative has the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the installing activity occurs, then the portion of the installing activity that relates to the agricultural or horticultural products is an MPGE activity.

(4) Consistency with section 263A. A Specified Cooperative that has MPGE agricultural or horticultural products for the taxable year must treat itself as a producer under section 263A with respect to the agricultural or horticultural products unless the Specified Cooperative is not subject to section 263A. A Specified Cooperative that currently is not properly accounting for its production activities under section 263A, and wishes to change its method of accounting to comply with the producer requirements of section 263A, must follow the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2015-13, 2015-5 IRB 419, or any applicable subsequent guidance (see §601.601(d)(2) of this chapter)).

(g) By the taxpayer. With respect to the exception of the rules applicable to an EAG and EAG partnerships under §1.199A-12, only one Specified Cooperative may claim the section 199A(g) deduction with respect to any qualifying activity under paragraph (f) of this section performed in connection with the same agricultural or horticultural product. If an unrelated party performs a qualifying activity under paragraph (f) of this section pursuant to a contract with a Specified Cooperative (or its patron as relevant under paragraph (a)(2) of this section), then only if the Specified Cooperative (or its patron) has the benefits and burdens of ownership of the agricultural or horticultural product under Federal income tax principles during the period in which the qualifying activity occurs is the Specified Cooperative (or its patron) treated as engaging in the qualifying activity.

(h) In whole or significant part defined--(1) In general. Agricultural or horticultural products must be MPGE in whole or significant part by the Specified

Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) and in whole or significant part within the United States to qualify under section 199A(g)(3)(D)(i). If a Specified Cooperative enters into a contract with an unrelated person for the unrelated person to MPGE agricultural or horticultural products for the Specified Cooperative and the Specified Cooperative has the benefits and burdens of ownership of the agricultural or horticultural products under applicable Federal income tax principles during the period the MPGE activity occurs, then, pursuant to paragraph (g) of this section, the Specified Cooperative is considered to MPGE the agricultural or horticultural products under this section. The unrelated person must perform the MPGE activity on behalf of the Specified Cooperative in whole or significant part within the United States in order for the Specified Cooperative to satisfy the requirements of this paragraph (h)(1).

(2) Substantial in nature. Agricultural or horticultural products will be treated as MPGE in whole or in significant part by the Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) within the United States for purposes of paragraph (h)(1) of this section if the MPGE of the agricultural or horticultural products by the Specified Cooperative within the United States is substantial in nature taking into account all the facts and circumstances, including the relative value added by, and relative cost of, the Specified Cooperative's MPGE within the United States, the nature of the agricultural or horticultural products, and the nature of the MPGE activity that the Specified Cooperative performs within the United States. The MPGE of a key component of an agricultural or horticultural product does not, in itself, meet the substantial-in-nature requirement with respect to an agricultural or horticultural product

under this paragraph (h)(2). In the case of an agricultural or horticultural product, research and experimental activities under section 174 and the creation of intangible assets are not taken into account in determining whether the MPGE of the agricultural or horticultural product is substantial in nature.

(3) Safe harbor--(i) In general. A Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) will be treated as having MPGE an agricultural or horticultural product in whole or in significant part within the United States for purposes of paragraph (h)(1) of this section if the direct labor and overhead of such Specified Cooperative to MPGE the agricultural or horticultural product within the United States account for 20 percent or more of the Specified Cooperative's COGS of the agricultural or horticultural product, or in a transaction without COGS (for example, a lease, rental, or license), account for 20 percent or more of the Specified Cooperative's unadjusted depreciable basis (as defined in paragraph (h)(3)(ii) of this section) in property included in the definition of agricultural or horticultural products. For Specified Cooperatives subject to section 263A, overhead is all costs required to be capitalized under section 263A except direct materials and direct labor. For Specified Cooperatives not subject to section 263A, overhead may be computed using a reasonable method based on all the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under section 263A if the Specified Cooperative were subject to section 263A. Research and experimental expenditures under section 174 and the costs of creating intangible assets are not taken into account in determining direct labor or overhead for any agricultural or horticultural product. In the case of agricultural or horticultural products, research and experimental

expenditures under section 174 and any other costs incurred in the creation of intangible assets may be excluded from COGS or unadjusted depreciable basis for purposes of determining whether the Specified Cooperative meets the safe harbor under this paragraph (h)(3). For Specified Cooperatives not subject to section 263A, the chosen reasonable method to compute overhead must be consistently applied from one taxable year to another and must clearly reflect the Specified Cooperative's portion of overhead not subject to section 263A. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for overhead must be consistent with any allocations under this paragraph (h)(3)(i).

(ii) Unadjusted depreciable basis. The term unadjusted depreciable basis means the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis does not reflect the reduction in basis for--

(A) Any portion of the basis the Specified Cooperative properly elects to treat as an expense under sections 179 or 179C; or

(B) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)).

(4) Special rules--(i) Contract with an unrelated person. If a Specified Cooperative enters into a contract with an unrelated person for the unrelated person to MPGE an agricultural or horticultural product within the United States for the Specified Cooperative, and the Specified Cooperative is considered to MPGE the agricultural or horticultural product pursuant to paragraph (f)(1) of this section, then, for purposes of

the substantial-in-nature requirement under paragraph (h)(2) of this section and the safe harbor under paragraph (h)(3)(i) of this section, the Specified Cooperative's MPGE activities or direct labor and overhead must include both the Specified Cooperative's MPGE activities or direct labor and overhead to MPGE the agricultural or horticultural product within the United States as well as the MPGE activities or direct labor and overhead of the unrelated person to MPGE the agricultural or horticultural product within the United States under the contract.

(ii) Aggregation. In determining whether the substantial-in-nature requirement under paragraph (h)(2) of this section or the safe harbor under paragraph (h)(3)(i) of this section is met at the time the Specified Cooperative disposes of an agricultural or horticultural product--

(A) An EAG member must take into account all of the previous MPGE activities or direct labor and overhead of the other members of the EAG;

(B) An EAG partnership as defined in §1.199A-12(i)(1) must take into account all of the previous MPGE activities or direct labor and overhead of all members of the EAG in which the partners of the EAG partnership are members (as well as the previous MPGE activities of any other EAG partnerships owned by members of the same EAG); and

(C) A member of an EAG in which the partners of an EAG partnership are members must take into account all of the previous MPGE activities or direct labor and overhead of the EAG partnership (as well as those of any other members of the EAG and any previous MPGE activities of any other EAG partnerships owned by members of the same EAG).

(i) United States defined. For purposes of section 199A(g), the term United States includes the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Consistent with its definition in section 7701(a)(9), the term United States does not include possessions and territories of the United States or the airspace or space over the United States and these areas.

(j) Derived from the lease, rental, license, sale, exchange, or other disposition--(1) In general--(i) Definition. The term derived from the lease, rental, license, sale, exchange, or other disposition is defined as, and limited to, the gross receipts directly derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products even if the Specified Cooperative has already recognized receipts from a previous lease, rental, license, sale, exchange, or other disposition of the same agricultural or horticultural products. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof.

(ii) Lease income. The financing and interest components of a lease of agricultural or horticultural products are considered to be derived from the lease of such agricultural or horticultural products. However, any portion of the lease income that is attributable to services or non-qualified property as defined in paragraph (j)(3) of this section is not derived from the lease of agricultural or horticultural products.

(iii) Income substitutes. The proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition to the extent they are substitutes for gross receipts that would qualify as DPGR.

(iv) Exchange of property--(A) Taxable exchanges. The value of property received by the Specified Cooperative in a taxable exchange of agricultural or horticultural products MPGE in whole or in significant part by the Specified Cooperative within the United States is DPGR for the Specified Cooperative (assuming all the other requirements of this section are met). However, unless the Specified Cooperative meets all of the requirements under this section with respect to any additional MPGE by the Specified Cooperative of the agricultural or horticultural products received in the taxable exchange, any gross receipts derived from the sale by the Specified Cooperative of the property received in the taxable exchange are non-DPGR, because the Specified Cooperative did not MPGE such property, even if the property was an agricultural or horticultural product in the hands of the other party to the transaction.

(B) Safe harbor. For purposes of paragraph (j)(1)(iv)(A) of this section, the gross receipts derived by the Specified Cooperative from the sale of eligible property (as defined in paragraph (j)(1)(iv)(C) of this section) received in a taxable exchange, net of any adjustments between the parties involved in the taxable exchange to account for differences in the eligible property exchanged (for example, location differentials and product differentials), may be treated as the value of the eligible property received by the Specified Cooperative in the taxable exchange. For purposes of the preceding sentence, the taxable exchange is deemed to occur on the date of the sale of the eligible property received in the taxable exchange by the Specified Cooperative, to the extent the sale occurs no later than the last day of the month following the month in which the exchanged eligible property is received by the Specified Cooperative. In addition, if the Specified Cooperative engages in any further MPGE activity with respect to the eligible property received in the taxable exchange, then, unless the Specified Cooperative meets the in-whole-or-in-significant-part requirement under paragraph (h)(1) of this section with respect to the property sold, for purposes of this paragraph (j)(1)(iv)(B), the Specified Cooperative must also value the property sold without taking into account the gross receipts attributable to the further MPGE activity.

(C) Eligible property. For purposes of paragraph (j)(1)(iv)(B) of this section, eligible property is--

(1) Oil, natural gas, or petrochemicals, or products derived from oil, natural gas, or petrochemicals; or

(2) Any other property or product designated by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(3) For this purpose, the term natural gas includes only natural gas extracted from a natural deposit and does not include, for example, methane gas extracted from a landfill. In the case of natural gas, production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas.

(2) Hedging transactions--(i) In general. For purposes of this section, if a transaction is a hedging transaction within the meaning of section 1221(b)(2)(A) and §1.1221-2(b), is properly identified as a hedging transaction in accordance with

§1.1221-2(f), and the risk being hedged relates to property described in section 1221(a)(1) that gives rise to DPGR or to property described in section 1221(a)(8) that is consumed in an activity that gives rise to DPGR, then--

(A) In the case of a hedge of purchases of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining COGS;

(B) In the case of a hedge of sales of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR; and

(C) In the case of a hedge of purchases of property described in section 1221(a)(8), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR.

(ii) Allocation. The income, deduction, gain and loss from hedging transactions described in paragraph (j)(2) of this section must be allocated between the patronage and nonpatronage (defined in §1.1388-1(f)) sourced income and related deductions of the Specified Cooperatives consistent with the cooperative's method for determining patronage and nonpatronage income and deductions.

(iii) Effect of identification and nonidentification. The principles of §1.1221-2(g) apply to a Specified Cooperative that identifies or fails to identify a transaction as a hedging transaction, except that the consequence of identifying as a hedging transaction a transaction that is not in fact a hedging transaction described in paragraph (j)(2) of this section, or of failing to identify a transaction that the Specified Cooperative has no reasonable grounds for treating as other than a hedging transaction described in paragraph (j)(2) of this section, is that deduction or loss (but not income or gain) from the transaction is taken into account under paragraph (j)(2) of this section.

(iv) Other rules. See §1.1221-2(e) for rules applicable to hedging by members of a consolidated group and §1.446-4 for rules regarding the timing of income, deductions, gains or losses with respect to hedging transactions.

(3) Allocation of gross receipts to embedded services and non-qualified property--(i) Embedded services and non-qualified property--(A) In general. Except as otherwise provided in paragraph (j)(3)(i)(B) of this section, gross receipts derived from the performance of services do not qualify as DPGR. In the case of an embedded service, that is, a service the price of which, in the normal course of the business, is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products, DPGR includes only the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products (assuming all the other requirements of this section are met) and not any receipts attributable to the embedded service. In addition, DPGR does not include gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property that does not meet all of the requirements under this section (non-qualified property). The allocation of the gross receipts attributable to the embedded services or non-qualified property will be deemed to be reasonable if the allocation reflects the fair market value of the embedded services or non-qualified property.

(B) Exceptions. There are five exceptions to the rules under paragraph (j)(3)(i)(A) of this section regarding embedded services and non-qualified property. A Specified Cooperative may include in DPGR, if all the other requirements of this section are met with respect to the underlying item of agricultural or horticultural products to which the embedded services or non-qualified property relate, the gross receipts derived from--

(1) A qualified warranty, that is, a warranty that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products if, in the normal course of the Specified Cooperative's business--

(i) The price for the warranty is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The warranty is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the warranty);

(2) A qualified delivery, that is, a delivery or distribution service that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products if, in the normal course of the Specified Cooperative's business--

(i) The price for the delivery or distribution service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The delivery or distribution service is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the delivery or distribution service).

(3) A qualified operating manual, that is, a manual of instructions that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products if, in the normal course of the Specified Cooperative’s business--

(i) The price for the manual is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products;

(ii) The manual is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the manual); and

(iii) The manual is not provided in connection with a training course for customers.

(4) A qualified installation, that is, an installation service for agricultural or horticultural products that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products if, in the normal course of the Specified Cooperative’s business--

(i) The price for the installation service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(ii) The installation is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the installation service).

(5) A de minimis amount of gross receipts from embedded services and non-qualified property for each item of agricultural or horticultural products may qualify. For purposes of this exception, a de minimis amount of gross receipts from embedded services and non-qualified property is less than 5 percent of the total gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of each item of agricultural or horticultural products. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products that are received over a period of time (for example, a multi-year lease or installment sale), this de minimis exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of agricultural or horticultural products. For purposes of the preceding sentence, if a Specified Cooperative treats gross receipts as DPGR under this de minimis exception, then the Specified Cooperative must treat the gross receipts recognized in each taxable year consistently as DPGR. The gross receipts that the Specified Cooperative treats as DPGR under paragraphs (j)(3)(i)(B)(1) through (4) of this section are treated as DPGR for purposes of applying this de minimis exception. This de minimis exception does not apply if the price of a service or non-qualified property is separately stated by the Specified Cooperative, or if the service or non-qualified property is separately offered or

separately bargained for with the customer (that is, the customer can purchase the agricultural or horticultural products without the service or non-qualified property).

(ii) Non-DPGR. Applicable gross receipts as provided in §§1.199A-8(b) and/or (c) derived from the lease, rental, license, sale, exchange or other disposition of an item of agricultural or horticultural products may be treated as non-DPGR if less than 5 percent of the Specified Cooperative's total gross receipts derived from the lease, rental, license, sale, exchange or other disposition of that item are DPGR (taking into account embedded services and non-qualified property included in such disposition, but not part of the item). In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products that are received over a period of time (for example, a multi-year lease or installment sale), this paragraph (j)(5)(ii) is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of agricultural or horticultural products. For purposes of the preceding sentence, if the Specified Cooperative treats gross receipts as non-DPGR under this de minimis exception, then the Specified Cooperative must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(k) Applicability date. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

§1.199A-10 Allocation of costs of goods sold (COGS) and other deductions to domestic production gross receipts (DPGR), and other rules.

(a) In general. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide additional guidance on determining qualified production activities income (QPAI) as described and defined in §1.199A-8(b)(4)(ii).

(b) COGS allocable to DPGR--(1) In general. When determining its QPAI, the Specified Cooperative (defined in §1.199A-8(a)(2)) must subtract from its DPGR (defined in §1.199A-8(b)(3)(ii)) the COGS allocable to its DPGR. The Specified Cooperative determines its COGS allocable to DPGR in accordance with this paragraph (b)(1) or, if applicable, paragraph (f) of this section. In the case of a sale, exchange, or other disposition of inventory, COGS is equal to beginning inventory of the Specified Cooperative plus purchases and production costs incurred during the taxable year and included in inventory costs by the Specified Cooperative, less ending inventory of the Specified Cooperative. In determining its QPAI, the Specified Cooperative does not include in COGS any payment made, whether during the taxable year, or included in beginning inventory, for which a deduction is allowed under section 1382(b) and/or (c), as applicable. See §1.199A-8(b)(4)(C). COGS is determined under the methods of accounting that the Specified Cooperative uses to compute taxable income. See sections 263A, 471, and 472. If section 263A requires the Specified Cooperative to include additional section 263A costs (as defined in §1.263A-1(d)(3)) in inventory, additional section 263A costs must be included in determining COGS. COGS also includes the Specified Cooperative's inventory valuation adjustments such as write-downs under the lower of cost or market method. In the case of a sale, exchange, or other disposition (including, for example, theft, casualty, or abandonment) by the Specified Cooperative of non-inventory property, COGS for purposes of this section includes the adjusted basis of the property.

(2) Allocating COGS--(i) In general. A Specified Cooperative must use a reasonable method based on all the facts and circumstances to allocate COGS between DPGR and non-DPGR. Whether an allocation method is reasonable is based on all the facts and circumstances, including whether the Specified Cooperative uses the most accurate information available; the relationship between COGS and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the availability of costing information; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year. Depending on the facts and circumstances, reasonable methods may include methods based on gross receipts (defined in §1.199A-8(b)(2)(iii)), number of units sold, number of units produced, or total production costs. Ordinarily, if a Specified Cooperative uses a method to allocate gross receipts between DPGR and non-DPGR, then the use of a different method to allocate COGS that is not demonstrably more accurate than the method used to allocate gross receipts will not be considered reasonable. However, if a Specified Cooperative has information readily available to specifically identify COGS allocable to DPGR and can specifically identify that amount without undue burden or expense, COGS allocable to DPGR is that amount

irrespective of whether the Specified Cooperative uses another allocation method to allocate gross receipts between DPGR and non-DPGR. A Specified Cooperative that does not have information readily available to specifically identify COGS allocable to DPGR and that cannot, without undue burden or expense, specifically identify that amount is not required to use a method that specifically identifies COGS allocable to DPGR. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of COGS between DPGR and non-DPGR. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for COGS must be consistent with any allocations under this paragraph (b)(2).

(ii) Gross receipts recognized in an earlier taxable year. If the Specified Cooperative (other than a Specified Cooperative that uses the small business simplified overall method of paragraph (f) of this section) recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs COGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the Specified Cooperative must allocate the COGS to--

(A) DPGR if the Specified Cooperative identified the related gross receipts as DPGR in the prior taxable year; or

(B) Non-DPGR if the Specified Cooperative identified the related gross receipts as non-DPGR in the prior taxable year or if the Specified Cooperative recognized under the Specified Cooperative’s methods of accounting those gross receipts in a taxable year to which section 199A(g) does not apply.

(iii) COGS associated with activities undertaken in an earlier taxable year--(A) In general. A Specified Cooperative must allocate its COGS between DPGR and non-DPGR under the rules provided in paragraphs (b)(2)(i) and (iii) of this section, regardless of whether certain costs included in its COGS can be associated with activities undertaken in an earlier taxable year (including a year prior to the effective date of section 199A(g)). A Specified Cooperative may not segregate its COGS into component costs and allocate those component costs between DPGR and non-DPGR.

(B) Example. The following example illustrates an application of paragraph (b)(2)(iii)(A) of this section.

(1) Example. During the 2018 taxable year, nonexempt Specified Cooperative X grew and sold Horticultural Product A. All of the patronage gross receipts from sales recognized by X in 2018 were from the sale of Horticultural Product A and qualified as DPGR. Employee 1 of X was involved in X's production process until he retired in 2013. In 2018, X paid $30 directly from its general assets for Employee 1's medical expenses pursuant to an unfunded, self-insured plan for retired X employees. For purposes of computing X's 2018 taxable income, X capitalized those medical costs to inventory under section 263A. In 2018, the COGS for a unit of Horticultural Product A was $100 (including the applicable portion of the $30 paid for Employee 1's medical costs that was allocated to COGS under X's allocation method for additional section 263A costs). X has information readily available to specifically identify COGS allocable to DPGR and can identify that amount without undue burden and expense because all of X's gross receipts from sales in 2018 are attributable to the sale of Horticultural Product A and qualify as DPGR. The inventory cost of each unit of Horticultural Product A sold in 2018, including the applicable portion of retiree medical costs, is related to X's gross receipts from the sale of Horticultural Product A in 2018. X may not segregate the 2018 COGS by separately allocating the retiree medical costs, which are components of COGS, to DPGR and non-DPGR. Thus, even though the retiree medical costs can be associated with activities undertaken in prior years, $100 of inventory cost of each unit of Horticultural Product A sold in 2018, including the applicable portion of the retiree medical expense cost component, is allocable to DPGR in 2018.

(3) Special allocation rules. Section 199A(g)(3)(C) provides the following two special rules--

(i) For purposes of determining the COGS that are allocable to DPGR, any item or service brought into the United States (defined in §1.199A-9(i)) is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the United States. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to DPGR.

(ii) In the case of any property described in paragraph (b)(3)(i) of this section that has been exported by the Specified Cooperative for further manufacture, the increase in cost or adjusted basis under paragraph (b)(3)(i) of this section cannot exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture. For the purposes of this paragraph (b)(3), the value of property is its customs value as defined in section 1059A(b)(1).

(4) <u>Rules for inventories valued at market or bona fide selling prices</u>. If part of COGS is attributable to the Specified Cooperative's inventory valuation adjustments, then COGS allocable to DPGR includes inventory adjustments to agricultural or horticultural products that are MPGE in whole or significant part within the United States. Accordingly, a Specified Cooperative that values its inventory under §1.471-4 (inventories at cost or market, whichever is lower) or §1.471-2(c) (subnormal goods at bona fide selling prices) must allocate a proper share of such adjustments (for example, write-downs) to DPGR based on a reasonable method based on all the facts and circumstances. Factors taken into account in determining whether the method is reasonable include whether the Specified Cooperative uses the most accurate information available; the relationship between the adjustment and the allocation base

chosen; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year. If the Specified Cooperative has information readily available to specifically identify the proper amount of inventory valuation adjustments allocable to DPGR, then the Specified Cooperative must allocate that amount to DPGR. The Specified Cooperative that does not have information readily available to specifically identify the proper amount of its inventory valuation adjustments allocable to DPGR and that cannot, without undue burden or expense, specifically identify the proper amount of its inventory valuation adjustments allocable to DPGR, is not required to use a method that specifically identifies inventory valuation adjustments to DPGR. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect inventory adjustments. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for inventory adjustments must be consistent with any allocations under this paragraph (b)(4).

(5) <u>Rules applicable to inventories accounted for under the last-in, first-out inventory method</u>--(i) <u>In general</u>. This paragraph (b)(5) applies to inventories accounted for using the specific goods last-in, first-out (LIFO) method or the dollar-value LIFO method. Whenever a specific goods grouping or a dollar-value pool contains agricultural or horticultural products that produce DPGR and goods that do not, the Specified Cooperative must allocate COGS attributable to that grouping or pool

between DPGR and non-DPGR using a reasonable method based on all the facts and circumstances. Whether a method of allocating COGS between DPGR and non-DPGR is reasonable must be determined in accordance with paragraph (b)(2) of this section. In addition, this paragraph (b)(5) provides methods that a Specified Cooperative may use to allocate COGS for a Specified Cooperative's inventories accounted for using the LIFO method. If the Specified Cooperative uses the LIFO/FIFO ratio method provided in paragraph (b)(5)(ii) of this section or the change in relative base-year cost method provided in paragraph (b)(5)(iii) of this section, then the Specified Cooperative must use that method for all of the Specified Cooperative's inventory accounted for under the LIFO method. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the inventory method. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for the inventory method must be consistent with any allocations under this paragraph (b)(5).

(ii) <u>LIFO/FIFO ratio method</u>. The LIFO/FIFO ratio method is applied with respect to the LIFO inventory on a grouping-by-grouping or pool-by-pool basis. Under the LIFO/FIFO ratio method, a Specified Cooperative computes the COGS of a grouping or pool allocable to DPGR by multiplying the COGS of agricultural or horticultural products (defined in §1.199A-8(a)(4)) in the grouping or pool that produced DPGR computed using the FIFO method by the LIFO/FIFO ratio of the grouping or pool. The LIFO/FIFO ratio of a grouping or pool is equal to the total COGS of the grouping or pool computed using the LIFO method over the total COGS of the grouping or pool computed using the FIFO method.

(iii) Change in relative base-year cost method. A Specified Cooperative using the dollar-value LIFO method may use the change in relative base-year cost method. The change in relative base-year cost method for a Specified Cooperative using the dollar-value LIFO method is applied to all LIFO inventory on a pool-by-pool basis. The change in relative base-year cost method determines the COGS allocable to DPGR by increasing or decreasing the total production costs (section 471 costs and additional section 263A costs) of agricultural or horticultural products that generate DPGR by a portion of any increment or liquidation of the dollar-value pool. The portion of an increment or liquidation allocable to DPGR is determined by multiplying the LIFO value of the increment or liquidation (expressed as a positive number) by the ratio of the change in total base-year cost (expressed as a positive number) of agricultural or horticultural products that will generate DPGR in ending inventory to the change in total base-year cost (expressed as a positive number) of all goods in ending inventory. The portion of an increment or liquidation allocable to DPGR may be zero but cannot exceed the amount of the increment or liquidation. Thus, a ratio in excess of 1.0 must be treated as 1.0.

(6) Specified Cooperative using a simplified method for additional section 263A costs to ending inventory. A Specified Cooperative that uses a simplified method specifically described in the section 263A regulations to allocate additional section 263A costs to ending inventory must follow the rules in paragraph (b)(2) of this section to determine the amount of additional section 263A costs allocable to DPGR. Allocable additional section 263A costs include additional section 263A costs included in the Specified Cooperative's beginning inventory as well as additional section 263A costs

incurred during the taxable year by the Specified Cooperative. Ordinarily, if the Specified Cooperative uses a simplified method specifically described in the section 263A regulations to allocate its additional section 263A costs to its ending inventory, the additional section 263A costs must be allocated in the same proportion as section 471 costs are allocated.

(c) Other deductions properly allocable to DPGR or gross income attributable to DPGR--(1) In general. In determining its QPAI, the Specified Cooperative must subtract from its DPGR (in addition to the COGS), the deductions that are properly allocable and apportioned to DPGR. A Specified Cooperative generally must allocate and apportion these deductions using the rules of the section 861 method provided in paragraph (d) of this section. In lieu of the section 861 method, an eligible Specified Cooperative may apportion these deductions using the simplified deduction method provided in paragraph (e) of this section. Paragraph (f) of this section provides a small business simplified overall method that may be used by a qualifying small Specified Cooperative. A Specified Cooperative using the simplified deduction method or the small business simplified overall method must use that method for all deductions. A Specified Cooperative eligible to use the small business simplified overall method may choose at any time for any taxable year to use the small business simplified overall method or the simplified deduction method for a taxable year.

(2) Treatment of net operating losses. A deduction under section 172 for a net operating loss (NOL) is not allocated or apportioned to DPGR or gross income attributable to DPGR.

(3) W-2 wages. Although only W-2 wages as described in §1.199A-11 are taken into account in computing the W-2 wage limitation, all wages paid (or incurred in the case of an accrual method taxpayer) in the taxable year are taken into account in computing QPAI for that taxable year.

(d) Section 861 method. Under the section 861 method, the Specified Cooperative must allocate and apportion its deductions using the allocation and apportionment rules provided under the section 861 regulations under which section 199A(g) is treated as an operative section described in §1.861-8(f). Accordingly, the Specified Cooperative applies the rules of the section 861 regulations to allocate and apportion deductions (including, if applicable, its distributive share of deductions from passthrough entities) to gross income attributable to DPGR. If the Specified Cooperative applies the allocation and apportionment rules of the section 861 regulations for section 199A(g) and another operative section, then the Specified Cooperative must use the same method of allocation and the same principles of apportionment for purposes of all operative sections. Research and experimental expenditures must be allocated and apportioned in accordance with §1.861-17 without taking into account the exclusive apportionment rule of §1.861-17(b). Deductions for charitable contributions (as allowed under section 170 and section 873(b)(2) or 882(c)(1)(B)) must be ratably apportioned between gross income attributable to DPGR and gross income attributable to non-DPGR based on the relative amounts of gross income.

(e) Simplified deduction method--(1) In general. An eligible Specified Cooperative (defined in paragraph (e)(2) of this section) may use the simplified deduction method to apportion business deductions between DPGR and non-DPGR. The simplified deduction method does not apply to COGS. Under the simplified deduction method, the business deductions (except the NOL deduction) are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions for the current taxable year apportioned to DPGR is equal to the proportion of the total business deductions for the current taxable year that the amount of DPGR bears to total gross receipts.

(2) Eligible Specified Cooperative. For purposes of this paragraph (e), an eligible Specified Cooperative is--

(i) A Specified Cooperative that has average annual total gross receipts (as defined in paragraph (g) of this section) of $100,000,000 or less; or

(ii) A Specified Cooperative that has total assets (as defined in paragraph (e)(3) of this section) of $10,000,000 or less.

(3) Total assets.--(i) In general. For purposes of the simplified deduction method, total assets mean the total assets the Specified Cooperative has at the end of the taxable year.

(ii) Members of an expanded affiliated group. To compute the total assets of an expanded affiliated group (EAG) at the end of the taxable year, the total assets at the end of the taxable year of each member of the EAG at the end of the taxable year that ends with or within the taxable year of the computing member (as described in §1.199A-12(g)) are aggregated.

(4) Members of an expanded affiliated group--(i) In general. Whether the members of an EAG may use the simplified deduction method is determined by

reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $100,000,000 or the total assets of the EAG are less than or equal to $10,000,000, then each member of the EAG may individually determine whether to use the simplified deduction method, regardless of the cost allocation method used by the other members.

(ii) Exception. Notwithstanding paragraph (e)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(f) Small business simplified overall method--(1) In general. A qualifying small Specified Cooperative may use the small business simplified overall method to apportion COGS and deductions between DPGR and non-DPGR. Under the small business simplified overall method, a Specified Cooperative's total costs for the current taxable year (as defined in paragraph (f)(3) of this section) are apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of total costs for the current taxable year apportioned to DPGR is equal to the proportion of total costs for the current taxable year that the amount of DPGR bears to total gross receipts.

(2) Qualifying small Specified Cooperative. For purposes of this paragraph (f), a qualifying small Specified Cooperative is a Specified Cooperative that has average annual total gross receipts (as defined in paragraph (g) of this section) of $25,000,000 or less.

(3) Total costs for the current taxable year. For purposes of the small business simplified overall method, total costs for the current taxable year means the total COGS and deductions for the current taxable year. Total costs for the current taxable year are

determined under the methods of accounting that the Specified Cooperative uses to compute taxable income.

(4) Members of an expanded affiliated group--(i) In general. Whether the members of an EAG may use the small business simplified overall method is determined by reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $25,000,000 then each member of the EAG may individually determine whether to use the small business simplified overall method, regardless of the cost allocation method used by the other members.

(ii) Exception. Notwithstanding paragraph (f)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(g) Average annual gross receipts--(1) In general. For purposes of the simplified deduction method and the small business simplified overall method, average annual gross receipts means the average annual gross receipts of the Specified Cooperative for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year, even if one or more of such taxable years began before the effective date of section 199A(g). In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts of the Specified Cooperative are annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(2) Members of an expanded affiliated group--(i) In general. To compute the average annual gross receipts of an EAG, the gross receipts for the entire taxable year of each member that is a member of the EAG at the end of its taxable year that ends

with or within the taxable year are aggregated. For purposes of this paragraph (g)(2), a consolidated group is treated as one member of an EAG.

(ii) Exception. Notwithstanding paragraph (g)(1)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(h) Cost allocation methods for determining oil-related QPAI--(1) Section 861 method. A Specified Cooperative that uses the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to DPGR must use the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to oil-related DPGR.

(2) Simplified deduction method. A Specified Cooperative that uses the simplified deduction method to apportion deductions between DPGR and non-DPGR must determine the portion of deductions allocable to oil-related DPGR by multiplying the deductions allocable to DPGR by the ratio of oil-related DPGR to DPGR from all activities.

(3) Small business simplified overall method. A Specified Cooperative that uses the small business simplified overall method to apportion total costs (COGS and deductions) between DPGR and non-DPGR must determine the portion of total costs allocable to oil-related DPGR by multiplying the total costs allocable to DPGR by the ratio of oil-related DPGR to DPGR from all activities.

(i) Applicability date. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

§1.199A-11 Wage limitation for the section 199A(g) deduction.

(a) Rules of application--(1) In general. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide guidance on determining the W-2 wage limitation as defined in §1.199A-8(b)(5)(ii)(B). Except as provided in paragraph (d)(2) of this section, the Form W-2, Wage and Tax Statement, or any subsequent form or document used in determining the amount of W-2 wages, are those issued for the calendar year ending during the taxable year of the Specified Cooperative (defined in §1.199A-8(a)(2)) for wages paid to employees (or former employees) of the Specified Cooperative for employment by the Specified Cooperative. Employees are limited to employees defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). See paragraph (a)(5) of this section for the requirement that W-2 wages must have been included in a return filed with the Social Security Administration (SSA) within 60 days after the due date (including extensions) of the return. See also section 199A(a)(4)(C).

(2) Wage limitation for section 199A(g) deduction. The amount of the deduction allowable under section 199A(g) to the Specified Cooperative for any taxable year cannot exceed 50 percent of the W-2 wages (as defined in section 199A(g)(1)(B)(ii) and paragraph (b) of this section) for the taxable year that are attributable to domestic production gross receipts (DPGR), defined in §1.199A-8(b)(3)(ii), of agricultural or horticultural products defined in §1.199A-8(a)(4).

(3) Wages paid by entity other than common law employer. In determining W-2 wages, the Specified Cooperative may take into account any W-2 wages paid by another entity and reported by the other entity on Forms W-2 with the other entity as the employer listed in Box c of the Forms W-2, provided that the W-2 wages were paid to common law employees or officers of the Specified Cooperative for employment by the Specified Cooperative. In such cases, the entity paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining W-2 wages with respect to that entity. For purposes of this paragraph (a)(4), entities that pay and report W-2 wages on behalf of or with respect to other taxpayers can include, but are not limited to, certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(4) Requirement that wages must be reported on return filed with the Social Security Administration--(i) In general. Pursuant to section 199A(g)(1)(B)(ii) and section 199A(b)(4)(C), the term W-2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under §31.6051-2 of this chapter, each Form W-2 and the transmittal Form W-3, Transmittal of Wage and Tax Statements, together constitute an information return to be filed with SSA. Similarly, each Form W-2c, Corrected Wage and Tax Statement, and the transmittal Form W-3 or W-3c, Transmittal of Corrected Wage and Tax Statements, together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions)

for such return, each Form W-2 together with its accompanying Form W-3 is considered a separate information return and each Form W-2c together with its accompanying Form W-3 or Form W-3c is considered a separate information return. Section 6071(c) provides that Forms W-2 and W-3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in §31.6071(a)-1T(a)(3)(1) of this chapter for monthly returns filed under §31.6011(a)-5(a) of this chapter). Corrected Forms W-2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(ii) Corrected return filed to correct a return that was filed within 60 days of the due date. If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (a)(5)(iii) of this section does not apply, then the wage information on Return B must be included in determining W-2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), then if Return D reports an increase (or increases) in wages included in determining W-2 wages from the wage amounts reported on Return C, such increase (or increases) on Return D is disregarded in determining W-2 wages (and only the wage amounts on Return C may be included in determining W-2 wages). If Return D reports a decrease (or decreases) in wages included in determining W-2 wages from the amounts reported on Return C, then, in determining W-2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(iii) Corrected return filed to correct a return that was filed later than 60 days after the due date. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W-2c is filed to correct a Form W-2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2 (or to correct a Form W-2c relating to a Form W-2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W-2), then this Form W-2c is not to be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this Form W-2c, regardless of when the Form W-2c is filed.

(b) Definition of W-2 wages--(1) In general. Section 199A(g)(1)(B)(ii) provides that the W-2 wages of the Specified Cooperative must be determined in the same manner as under section 199A(b)(4) (without regard to section 199A(b)(4)(B) and after application of section 199A(b)(5)). Section 199A(b)(4)(A) provides that the term W-2 wages means with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W-2 wages includes the total amount of wages as defined in section 3401(a); the total amount of elective deferrals (within the meaning of section 402(g)(3)); the compensation deferred under section 457; and the amount of designated Roth contributions (as defined in section 402A).

(2) Section 199A(g) deduction. Pursuant to section 199A(g)(3)(A), W-2 wages do not include any amount which is not properly allocable to DPGR for purposes of calculating qualified production activities income (QPAI) as defined in §1.199A-8(b)(4)(ii). The Specified Cooperative may determine the amount of wages that is properly allocable to DPGR using a reasonable method based on all the facts and circumstances. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the wages allocable to DPGR for purposes of QPAI. The books and records maintained for wages allocable to DPGR for purposes of QPAI must be consistent with any allocations under this paragraph (b)(2).

(c) Methods for calculating W-2 wages. The Secretary may provide for methods to be used in calculating W-2 wages, including W-2 wages for short taxable years by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter).

(d) Wage limitation -- acquisitions, dispositions, and short taxable years--(1) In general. For purposes of computing the deduction under section 199A(g) of the Specified Cooperative, in the case of an acquisition or disposition (as defined in section 199A(b)(5) and paragraph (d)(3) of this section) that causes more than one Specified Cooperative to be an employer of the employees of the acquired or disposed of Specified Cooperative during the calendar year, the W-2 wages of the Specified Cooperative for the calendar year of the acquisition or disposition are allocated between or among each Specified Cooperative based on the period during which the employees of the acquired or disposed of Specified Cooperatives were employed by the Specified Cooperative, regardless of which permissible method is used for reporting predecessor and successor wages on Form W-2, Wage and Tax Statement.

(2) Short taxable year that does not include December 31. If the Specified Cooperative has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by the Specified Cooperative during the short taxable year are treated as W-2 wages for such short taxable year for purposes of paragraph (a) of this section (if the wages would otherwise meet the requirements to be W-2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(3) Acquisition or disposition. For purposes of paragraph (d)(1) and (2) of this section, the terms acquisition and disposition include an incorporation, a liquidation, a reorganization, or a purchase or sale of assets.

(e) Application in the case of a Specified Cooperative with a short taxable year. In the case of a Specified Cooperative with a short taxable year, subject to the rules of paragraph (a) of this section, the W-2 wages of the Specified Cooperative for the short taxable year can include only those wages paid during the short taxable year to employees of the Specified Cooperative, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the Specified Cooperative, and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the Specified Cooperative.

(f) Non-duplication rule. Amounts that are treated as W-2 wages for a taxable year under any method cannot be treated as W-2 wages of any other taxable year.

Also, an amount cannot be treated as W-2 wages by more than one taxpayer. Finally, an amount cannot be treated as W-2 wages by the Specified Cooperative both in determining patronage and nonpatronage W-2 wages.

(g) Wage expense safe harbor--(1) In general. A Specified Cooperative using either the section 861 method of cost allocation under §1.199A-10(d) or the simplified deduction method under §1.199A-10(e) may determine the amount of W-2 wages that are properly allocable to DPGR for a taxable year by multiplying the amount of W-2 wages determined under paragraph (b)(1) of this section for the taxable year by the ratio of the Specified Cooperative’s wage expense included in calculating QPAI for the taxable year to the Specified Cooperative’s total wage expense used in calculating the Specified Cooperative’s taxable income for the taxable year, without regard to any wage expense disallowed by section 465, 469, 704(d), or 1366(d). A Specified Cooperative that uses either the section 861 method of cost allocation or the simplified deduction method to determine QPAI must use the same expense allocation and apportionment methods that it uses to determine QPAI to allocate and apportion wage expense for purposes of this safe harbor. For purposes of this paragraph (g)(1), the term wage expense means wages (that is, compensation paid by the employer in the active conduct of a trade or business to its employees) that are properly taken into account under the Specified Cooperative’s method of accounting.

(2) Wage expense included in cost of goods sold. For purposes of paragraph (g)(1) of this section, a Specified Cooperative may determine its wage expense included in cost of goods sold (COGS) using a reasonable method based on all the facts and circumstances, such as using the amount of direct labor included in

COGS or using section 263A labor costs (as defined in §1.263A-1(h)(4)(ii)) included in COGS. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of wage expense included in COGS. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for wage expense included in COGS must be consistent with any allocations under this paragraph (g)(2).

(3) Small business simplified overall method safe harbor. The Specified Cooperative that uses the small business simplified overall method under §1.199A-10(f) may use the small business simplified overall method safe harbor for determining the amount of W-2 wages determined under paragraph (b)(1) of this section that is properly allocable to DPGR. Under this safe harbor, the amount of W-2 wages determined under paragraph (b)(1) of this section that is properly allocable to DPGR is equal to the same proportion of W-2 wages determined under paragraph (b)(1) of this section that the amount of DPGR bears to the Specified Cooperative's total gross receipts.

(h) Applicability date. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

§1.199A-12 Expanded affiliated groups.

(a) In general. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). Except as otherwise provided in the Code or regulations issued under the relevant section of the Code (for example, sections 199A(g)(3)(D)(ii) and 267, §1.199A-8(c), paragraph (a)(3) of this section, and the consolidated return regulations under section 1502, each Specified Cooperative whether exempt or nonexempt (as defined in §1.199A-8(a)(2)(iii)) that is a member of an expanded affiliated group (EAG) (defined in paragraph (a)(1) of this section) computes its own taxable income or loss, qualified production activities income (QPAI) (defined in §1.199A-8(b)(4)(ii)), and W-2 wages (defined in §1.199A-11(b)). If a Specified Cooperative is also a member of a consolidated group, see paragraph (d) of this section.

(1) Definition of an expanded affiliated group. An EAG is an affiliated group as defined in section 1504(a), determined by substituting “more than 50 percent” for “at least 80 percent” in each place it appears and without regard to section 1504(b)(2) and (4).

(2) Identification of members of an expanded affiliated group--(i) In general. Each Specified Cooperative must determine if it is a member of an EAG on a daily basis.

(ii) Becoming or ceasing to be a member of an expanded affiliated group. If a Specified Cooperative becomes or ceases to be a member of an EAG, the Specified Cooperative is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes.

(3) Attribution of activities--(i) In general. Except as provided in paragraph (a)(3)(iv) of this section, if a Specified Cooperative that is a member of an EAG (disposing member) derives gross receipts (defined in §1.199A-8(b)(2)(iii)) from the lease, rental, license, sale, exchange, or other disposition (defined in §1.199A-9(j))

of agricultural or horticultural products (defined in §1.199A-8(a)(4)) that were manufactured, produced, grown or extracted (MPGE) (as defined in §1.199A-9(f)), in whole or significant part (as defined in §1.199A-9(h)) in the United States (as defined in §1.199A-9(i)) by another Specified Cooperative, then the disposing member is treated as conducting the previous activities conducted by such other Specified Cooperative with respect to the agricultural or horticultural products in determining whether its gross receipts are domestic production gross receipts (DPGR) (defined in §1.199A-8(b)(3)(ii)) if--

(A) Such property was MPGE by such other Specified Cooperative, and

(B) The disposing member is a member of the same EAG as such other Specified Cooperative at the time that the disposing member disposes of the agricultural or horticultural products.

(ii) Date of disposition for leases, rentals, or licenses. Except as provided in paragraph (a)(3)(iv) of this section, with respect to a lease, rental, or license, the disposing member described in paragraph (a)(3)(i) of this section is treated as having disposed of the agricultural or horticultural products on the date or dates on which it takes into account the gross receipts derived from the lease, rental, or license under its methods of accounting.

(iii) Date of disposition for sales, exchanges, or other dispositions. Except as provided in paragraph (a)(3)(iv) of this section, with respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the agricultural or horticultural products on the date on which it ceases to own the agricultural or horticultural products for Federal income tax purposes, even if no gain or loss is taken into account.

(iv) Exception. Nonexempt Specified Cooperatives. A nonexempt Specified Cooperative is not attributed nonpatronage activities conducted by another Specified Cooperative. See §1.199A-8(b)(2)(ii).

(4) Marketing Specified Cooperatives. A Specified Cooperative will be treated as having MPGE in whole or significant part any agricultural or horticultural product within the United States marketed by the Specified Cooperative which its patrons have so MPGE. Patrons are defined in §1.1388-1(e).

(5) Anti-avoidance rule. If a transaction between members of an EAG is engaged in or structured with a principal purpose of qualifying for, or increasing the amount of, the section 199A(g) deduction of the EAG or the portion of the section 199A(g) deduction allocated to one or more members of the EAG, the Secretary may make adjustments to eliminate the effect of the transaction on the computation of the section 199A(g) deduction.

(b) Computation of EAG's section 199A(g) deduction.--(1) In general. The section 199A(g) deduction for an EAG is determined by separately computing the section 199A(g) deduction from the patronage sources of Specified Cooperatives that are members of the EAG and the section 199A(g) deduction from the nonpatronage sources of exempt Specified Cooperatives that are members of the EAG. The section 199A(g) deduction from patronage sources of Specified Cooperatives is determined by aggregating the income or loss, QPAI, and W-2 wages, if any, of each patronage source of a Specified Cooperative that is a member of the EAG (whether an exempt or nonexempt Specified Cooperative). The section 199A(g) deduction from nonpatronage sources of exempt Specified Cooperatives is determined by aggregating the income or loss, QPAI, and W-2 wages, if any, of each nonpatronage source of exempt Specified Cooperatives that are members of the EAG. For purposes of this determination, a member's QPAI may be positive or negative. A Specified Cooperative's taxable income or loss and QPAI will be determined by reference to the Specified Cooperative's method of accounting. For purposes of determining the section 199A(g) deduction for an EAG, taxable income or loss, QPAI, and W-2 wages of a nonexempt Specified Cooperative from nonpatronage sources are considered to be zero. See §1.199A-8(b)(2)(ii).

(2) Example. The following examples illustrates the application of paragraph (b)(1) of this section.

(i) Example. Nonexempt Specified Cooperatives X, Y, and Z, calendar year taxpayers, are the only members of an EAG and are not members of a consolidated group. X's patronage source has taxable income of $50,000, QPAI of $15,000, and W-2 wages of $0. Y has patronage source taxable income of ($20,000), QPAI of ($1,000), and W-2 wages of $750. Z's patronage source has taxable income of $0, QPAI of $0, and W-2 wages of $3,000. In determining the EAG's section 199A(g) deduction, the EAG aggregates each member's patronage source's taxable income or loss, QPAI, and W-2 wages. Thus, the EAG's patronage source has taxable income of $30,000, the sum of X's patronage source taxable income of $50,000, Y's patronage source taxable income of ($20,000), and Z's patronage source taxable income of $0. The EAG has QPAI of $14,000, the sum of X's QPAI of $15,000, Y's QPAI of ($1,000), and Z's QPAI of $0. The EAG has W-2 wages of $3,750, the sum of X's W-2 wages of $0, Y's W-2 wages of $750, and Z's W-2 wages of $3,000. Accordingly, the EAG's section 199A(g) deduction equals $1,260, 9% of $14,000, the lesser of the QPAI and patronage source taxable income, but not greater than $1,875, 50% of its W-2 wages of $3,750. This result would be the same if X had a nonpatronage source income or loss, because nonpatronage source income of a nonexempt Specified Cooperative is not taken into account in determining the section 199A(g) deduction.

(3) Net operating loss carryovers/carrybacks. In determining the taxable income of an EAG, if a Specified Cooperative has a net operating loss (NOL) from its patronage sources that may be carried over or carried back, if applicable, (in accordance with section 172), to the taxable year, then for purposes of determining the taxable income of the Specified Cooperative, the amount of the NOL used to offset taxable income cannot exceed the taxable income of the patronage source of that Specified Cooperative. Similarly, if a Specified Cooperative has an NOL from its nonpatronage sources that may be carried over to the taxable year, then for purposes of determining the taxable income of the Specified Cooperative, the amount of the NOL used to offset taxable income cannot exceed the taxable income of the nonpatronage sources of that Specified Cooperative.

(4) Losses used to reduce taxable income of an expanded affiliated group. The amount of an NOL sustained by a Specified Cooperative member of an EAG that is used in the year sustained in determining an EAG's taxable income limitation under §1.199A-8(b)(5)(ii)(C) (for nonexempt Specified Cooperatives) or §1.199A-8(c)(4)(i) (for

exempt Specified Cooperatives), as applicable, is not treated as an NOL carryover to any taxable year in determining the taxable income limitation under §1.199A-8(b)(5)(ii)(C) or §1.199A-8(c)(4)(i), as applicable. For purposes of this paragraph (b)(4), an NOL is considered to be used if it reduces an EAG's aggregate taxable income from patronage source or nonpatronage source, as the case may be, regardless of whether the use of the NOL actually reduces the amount of the section 199A(g) deduction that the EAG would otherwise derive. An NOL is not considered to be used to the extent that it reduces an EAG's aggregate taxable income from patronage source or nonpatronage source, as the case may be, to an amount less than zero. If more than one Specified Cooperative has an NOL used in the same taxable year to reduce the EAG's taxable income from patronage or nonpatronage sources, as the case may be, the respective NOLs are deemed used in proportion to the amount of each Specified Cooperative's NOL.

(5) Example. The following example illustrates the application of paragraph (b)(4) of this section.

(i) Example--(A) Facts. Nonexempt Specified Cooperatives A and B are the only two members of an EAG. A and B are both calendar year taxpayers and they do not join in the filing of a consolidated Federal income tax return. Neither A nor B had taxable income or loss prior to 2018. In 2018, A has patronage QPAI and taxable income of $1,000 and B has patronage QPAI of $1,000 and a patronage NOL of $1,500. A also has nonpatronage income of $3,000. B has no activities other than from its patronage activities. In 2019, A has patronage QPAI of $2,000 and patronage taxable income of $1,000 and B has patronage QPAI of $2,000 and patronage taxable income prior to the NOL deduction allowed under section 172 of $2,000. Neither A nor B has nonpatronage activities in 2019. A's and B's patronage activities have aggregate W-2 wages in excess of the section 199A(g)(1)(B) wage limitation in both 2018 and 2019.

(B) Section 199A(g) deduction for 2018. In determining the EAG's section 199A(g) deduction for 2018, A's $1,000 of QPAI and B's $1,000 of QPAI are aggregated, as are A's $1,000 of taxable income from its patronage activities and B's $1,500 NOL from its patronage activities. A's nonpatronage income is not included.

Thus, for 2018, the EAG has patronage QPAI of $2,000 and patronage taxable income of ($500). The EAG's section 199A(g) deduction for 2018 is 9% of the lesser of its patronage QPAI or its patronage taxable income. Because the EAG has a taxable loss from patronage sources in 2018, the EAG's section 199A(g) deduction is $0.

(C) Section 199A(a) deduction for 2019. In determining the EAG's section 199A deduction for 2019, A's patronage QPAI of $2,000 and B's patronage QPAI of $2,000 are aggregated, resulting in the EAG having patronage QPAI of $4,000. Also, $1,000 of B's patronage NOL from 2018 was used in 2018 to reduce the EAG's taxable income from patronage sources to $0. The remaining $500 of B's patronage NOL from 2018 is not considered to have been used in 2018 because it reduced the EAG's patronage taxable income to less than $0. Accordingly, for purposes of determining the EAG's taxable income limitation under §1.199A-8(b)(5) in 2019, B is deemed to have only a $500 NOL carryover from its patronage sources from 2018 to offset a portion of its 2019 taxable income from its patronage sources. Thus, B's taxable income from its patronage sources in 2019 is $1,500, which is aggregated with A's $1,000 of taxable income from its patronage sources. The EAG's taxable income limitation in 2019 is $2,500. The EAG's section 199A(g) deduction is 9% of the lesser of its patronage sourced QPAI of $4,000 and its taxable income from patronage sources of $2,500. Thus, the EAG's section 199A(g) deduction in 2019 is 9% of $2,500, or $225. The results for 2019 would be the same if neither A nor B had patronage sourced QPAI in 2018.

(c) Allocation of an expanded affiliated group's section 199A(g) deduction among members of the expanded affiliated group--(1) In general. An EAG's section 199A(g) deduction from its patronage sources, as determined in paragraph (b) of this section, is allocated among the Specified Cooperatives that are members of the EAG in proportion to each Specified Cooperative's patronage QPAI, regardless of whether the Specified Cooperative has patronage taxable income or W-2 wages for the taxable year. An EAG's section 199A(g) deduction from its nonpatronage sources, as determined in paragraph (b) of this section, is allocated among the Specified Cooperatives that are members of the EAG in proportion to each Specified Cooperative's nonpatronage QPAI, regardless of whether the Specified Cooperative has nonpatronage taxable income or W-2 wages for the taxable year. For these purposes, if a Specified Cooperative has negative patronage or nonpatronage QPAI, such QPAI is treated as zero. Pursuant to §1.199A-8(b)(6), a patronage section 199A(g) deduction can be applied only against patronage income and deductions. Pursuant to §1.199A-8(c)(ii), a nonpatronage section 199A(g) deduction and can be applied only against nonpatronage income and deductions.

(2) Use of section 199A(g) deduction to create or increase a net operating loss. If a Specified Cooperative that is a member of an EAG has some or all of the EAG's section 199A(g) deduction allocated to it under paragraph (c)(1) of this section and the amount allocated exceeds patronage or nonpatronage taxable income, determined as described in this section and prior to allocation of the section 199A(g) deduction, the section 199A(g) deduction will create an NOL for the patronage source or nonpatronage source. Similarly, if a Specified Cooperative that is a member of an EAG, prior to the allocation of some or all of the EAG's section 199A(g) deduction to the member, has a patronage or nonpatronage NOL for the taxable year, the portion of the EAG's section 199A(g) deduction allocated to the member will increase such NOL.

(d) Special rules for members of the same consolidated group--(1) Intercompany transactions. In the case of an intercompany transaction between consolidated group members S and B (as the terms intercompany transaction, S and B are defined in §1.1502-13(b)(1)), S takes the intercompany transaction into account in computing the section 199A(g) deduction at the same time and in the same proportion as S takes into account the income, gain, deduction, or loss from the intercompany transaction under §1.1502-13.

(2) Application of the simplified deduction method and the small business simplified overall method. For purposes of applying the simplified deduction method

under §1.199A-10(e) and the small business simplified overall method under §1.199A-10(f), a Specified Cooperative that is part of a consolidated group determines its QPAI using its members' DPGR, non-DPGR, cost of goods sold (COGS), and all other deductions, expenses, or losses (hereinafter deductions), determined after application of §1.1502-13.

(3) Determining the section 199A(g) deduction--(i) Expanded affiliated group consists of consolidated group and non-consolidated group members. In determining the section 199A(g) deduction, if an EAG includes Specified Cooperatives that are members of the same consolidated group and Specified Cooperatives that are not members of the same consolidated group, the consolidated taxable income or loss, QPAI, and W-2 wages, from patronage sources, if any, of the consolidated group (and not the separate taxable income or loss, QPAI, and W-2 wages from patronage sources of the members of the consolidated group), are aggregated with the taxable income or loss, QPAI, and W-2 wages, from patronage sources, if any, of the non-consolidated group members. A similar rule applies with respect to nonpatronage taxable income or loss, QPAI, and W-2 wages. For example, if A, B, C, S1, and S2 are Specified Cooperatives that are members of the same EAG, and A, S1, and S2 are members of the same consolidated group (the A consolidated group), then the A consolidated group is treated as one member of the EAG. Accordingly, the EAG is considered to have three members, the A consolidated group, B, and C. The consolidated taxable income or loss, QPAI, and W-2 wages from patronage sources, if any, of the A consolidated group are aggregated with the taxable income or loss from patronage sources, QPAI, and W-2 wages, if any, of B and C in determining the EAG's section 199A(g) deduction

from patronage sources. Similarly, the consolidated taxable income or loss, QPAI, and W-2 wages from nonpatronage sources, if any, of the A consolidated group are aggregated with the taxable income or loss from nonpatronage sources, QPAI, and W-2 wages, if any, of B and C in determining the EAG's section 199A(g) deduction from nonpatronage sources. Pursuant to §1.199A-8(b)(6), a patronage section 199A(g) deduction can be applied only against patronage income and deductions. Pursuant to §1.199A-8(c)(ii), a nonpatronage section 199A(g) deduction and can be applied only against nonpatronage income and deductions.

(ii) Expanded affiliated group consists only of members of a single consolidated group. If all of the Specified Cooperatives that are members of an EAG are also members of the same consolidated group, the consolidated group's section 199A(g) deduction is determined using the consolidated group's consolidated taxable income or loss, QPAI, and W-2 wages, from patronage sources or nonpatronage sources, as the case may be, rather than the separate taxable income or loss, QPAI, and W-2 wages from patronage sources or nonpatronage sources of its members.

(4) Allocation of the section 199A(g) deduction of a consolidated group among its members. The section 199A(g) deduction from patronage sources of a consolidated group (or the section 199A(g) deduction allocated to a consolidated group that is a member of an EAG) is allocated among the patronage sources of Specified Cooperatives in proportion to each Specified Cooperative's patronage QPAI, regardless of whether the Specified Cooperative has patronage separate taxable income or W-2 wages for the taxable year. In allocating the section 199A(g) deduction of a patronage source of a Specified Cooperative that is part of a consolidated group among patronage

sources of other members of the same group, any redetermination of a member's patronage receipts, COGS, or other deductions from an intercompany transaction under §1.1502-13(c)(1)(i) or (c)(4) is not taken into account for purposes of section 199A(g). Also, for purposes of this allocation, if a patronage source of a Specified Cooperative that is a member of a consolidated group has negative QPAI, the QPAI of the patronage source is treated as zero.

(e) Examples. The following examples illustrate the application of paragraphs (a) through (d) of this section.

(i) Example 1. Specified Cooperatives X, Y, and Z are members of the same EAG but are not members of a consolidated group. X, Y, and Z each files Federal income tax returns on a calendar year basis. None of X, Y, or Z have activities other than from its patronage sources. Prior to 2018, X had no taxable income or loss. In 2018, X has taxable income of $0, QPAI of $2,000, and W-2 wages of $0, Y has taxable income of $4,000, QPAI of $3,000, and W-2 wages of $500, and Z has taxable income of $4,000, QPAI of $5,000, and W-2 wages of $2,500. Accordingly, the EAG's patronage source taxable income is $8,000, the sum of X's taxable income of $0, Y's taxable income of $4,000, and Z's taxable income of $4,000. The EAG has QPAI of $10,000, the sum of X's QPAI of $2,000, Y's QPAI of $3,000, and Z's QPAI of $5,000. The EAG's W-2 wages are $3,000, the sum of X's W-2 wages of $0, Y's W-2 wages of $500, and Z's W-2 wages of $2,500. Thus, the EAG's section 199A(g) deduction for 2018 is $720 (9% of the lesser of the EAG's patronage source taxable income of $8,000 and the EAG's QPAI of $10,000, but no greater than 50% of its W-2 wages of $3,000, i.e., $1,500). Pursuant to paragraph (c)(1) of this section, the $720 section 199A(g) deduction is allocated to X, Y, and Z in proportion to their respective amounts of QPAI, that is $144 to X ($720 × $2,000/$10,000), $216 to Y ($720 × $3,000/$10,000), and $360 to Z ($720 × $5,000/$10,000). Although X's patronage source taxable income for 2018 determined prior to allocation of a portion of the EAG's section 199A(g) deduction to it was $0, pursuant to paragraph (c)(2) of this section, X will have an NOL from its patronage source for 2018 equal to $144, which will be a carryover to 2019.

(ii) Example 2. (A) Facts. Corporation X is the common parent of a consolidated group, consisting of X and Y, which has filed a consolidated Federal income tax return for many years. Corporation P is the common parent of a consolidated group, consisting of P and S, which has filed a consolidated Federal income tax return for many years. The X and P consolidated groups each file their consolidated Federal income tax returns on a calendar year basis. X, Y, P, and S are each Specified Cooperatives, and none of X, Y, P, or S has ever had activities other than from its patronage sources. The X consolidated group and the P consolidated group are members of the same EAG in 2019. In 2018, the X consolidated group incurred a consolidated net operating loss (CNOL) of $25,000. Neither P nor S (nor the P consolidated group) has ever incurred an NOL. In 2019, the X consolidated group has (prior to the deduction under section 172) taxable income of $8,000 and the P consolidated group has taxable income of $20,000. X's QPAI is $8,000, Y's QPAI is ($13,000), P's QPAI is $16,000 and S's QPAI is $4,000. There are sufficient W-2 wages to exceed the section 199A(g)(1)(B) limitation.

(B) Analysis. The X consolidated group uses $8,000 of its CNOL from 2018 to offset the X consolidated group's taxable income in 2019. None of the X consolidated group's remaining CNOL may be used to offset taxable income of the P consolidated group under paragraph (b)(3) of this section. Accordingly, for purposes of determining the EAG's section 199A(g) deduction for 2019, the EAG has taxable income of $20,000 (the X consolidated group's taxable income, after the deduction under section 172, of $0 plus the P consolidated group's taxable income of $20,000). The EAG has QPAI of $15,000 (the X consolidated group's QPAI of ($5,000) (X's $8,000 + Y's ($13,000)), and the P consolidated group's QPAI of $20,000 (P's $16,000 + S's $4,000)). The EAG's section 199A(g) deduction equals $1,350, 9% of the lesser of its taxable income of $20,000 and its QPAI of $15,000. The section 199A(g) deduction is allocated between the X and P consolidated groups in proportion to their respective QPAI. Because the X consolidated group has negative QPAI, all of the section 199A(g) deduction of $1,350 is allocated to the P consolidated group. This $1,350 is allocated between P and S, the members of the P consolidated group, in proportion to their QPAI. Accordingly, P is allocated $1,080 ($1,350 x ($16,000/$20,000) and S is allocated $270 ($1,350 x $4,000/$20,000)).

(f) Allocation of patronage income and loss by a Specified Cooperative that is a member of the expanded affiliated group for only a portion of the year--(1) In general. A Specified Cooperative that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W-2 wages between the portion of the taxable year that the Specified Cooperative is a member of the EAG and the portion of the taxable year that the Specified Cooperative is not a member of the EAG. This allocation of items is made by using the pro rata allocation method described in this paragraph (f)(1). Under the pro rata allocation method, an equal portion of patronage taxable income or loss, QPAI, and W-2 wages, and nonpatronage taxable income or loss, QPAI, and W-2 wages for the taxable year is assigned to each day of the Specified Cooperative's taxable year. Those items assigned to those days that the Specified Cooperative was a member of the EAG are then aggregated.

(2) Coordination with rules relating to the allocation of income under §1.1502-76(b). If §1.1502-76(b) (relating to items included in a consolidated return) applies to a Specified Cooperative that is a member of an EAG, then any allocation of items required under this paragraph (f) is made only after the allocation of the items pursuant to §1.1502-76(b).

(g) Total section 199A(g) deduction for a Specified Cooperative that is a member of an expanded affiliated group for some or all of its taxable year--(1) Member of the same EAG for the entire taxable year. If a Specified Cooperative is a member of the same EAG for its entire taxable year, the Specified Cooperative's section 199A(g) deduction for the taxable year (whether patronage sourced or nonpatronage sourced) is the amount of the section 199A(g) deduction allocated to it by the EAG under paragraph (c)(1) of this section.

(2) Member of the expanded affiliated group for a portion of the taxable year. If a Specified Cooperative is a member of an EAG for only a portion of its taxable year and is either not a member of any EAG or is a member of another EAG, or both, for another portion of the taxable year, the Specified Cooperative's section 199A(g) deduction for the taxable year (whether patronage sourced or nonpatronage sourced) is the sum of its section 199A(g) deductions for each portion of the taxable year.

(3) Example. The following example illustrates the application of paragraphs (f) and (g) of this section.

(i) Example--(A) Facts. Specified Cooperatives X and Y, calendar year taxpayers, are members of the same EAG for the entire 2018 taxable year. Specified

Cooperative Z, also a calendar year taxpayer, is a member of the EAG of which X and Y are members for the first half of 2018 and not a member of any EAG for the second half of 2018. Assume that X, Y, and Z each has W-2 wages in excess of the section 199A(g)(1)(B) wage limitation for all relevant periods. In 2018, X's patronage source has taxable income of $2,000 and QPAI of $600, Y's patronage source has a taxable loss of $400 and QPAI of ($200), and Z's patronage source has taxable income of $1,400 and QPAI of $2,400.

(B) Analysis. Pursuant to the pro rata allocation method, $700 of Z's 2018 patronage taxable income and $1,200 of its 2018 QPAI are allocated to the first half of the 2018 taxable year (the period in which Z is a member of the EAG) and $700 of Z's 2018 patronage taxable income and $1,200 of its 2018 QPAI are allocated to the second half of the 2018 taxable year (the period in which Z is not a member of any EAG). Accordingly, in 2018, the EAG has taxable income from patronage source of $2,300 (X's $2,000 + Y's ($400) + Z's $700) and QPAI of $1,600 (X's $600 + Y's ($200) + Z's $1,200). The EAG's section 199A(g) deduction for 2018 is $144 (9% of the lesser of the EAG's taxable income from patronage source of $2,300 or QPAI of $1,600). Pursuant to §1.199A-14(c)(1), this $144 deduction is allocated to X's, Y's, and Z's patronage source in proportion to their respective QPAI. Accordingly, X's patronage source is allocated $48 of the EAG's section 199A(g) deduction ($144 x ($600/($600 + $0 + $1,200))), Y's patronage source is allocated $0 of the EAG's section 199A(g) deduction ($144 x ($0 / ($600 + $0 + $1,200))), and Z's patronage source is allocated $96 of the EAG's section 199A(g) deduction ($144 x ($1,200 / ($600 + $0 + $1,200))). For the second half of 2018, Z's patronage source has taxable income of $700 and QPAI of $1,200. Therefore, for the second half of 2018, Z's patronage source has a section 199A(g) deduction of $63 (9% of the lesser of its taxable income of $700 or its QPAI of $1,200 for the second half of 2018). Accordingly, X's 2018 section 199A(g) deduction is $48 and Y's 2018 section 199A(g) deduction is $0. Z's 2018 section 199A(g) deduction is $159, the sum of the $96 section 199A(g) deduction of the EAG allocated to Z for the first half of 2018 and Z's $63 section 199A(g) deduction for the second half of 2018.

(h) Computation of section 199A(g) deduction for members of an expanded affiliated group with different taxable years--(1) In general. If Specified Cooperatives that are members of an EAG have different taxable years, in determining the section 199A(g) deduction of a member (the computing member), the computing member is required to take into account the taxable income or loss, determined without regard to the section 199A(g) deduction, QPAI, and W-2 wages of each other group member that are both--

(i) Attributable to the period that each other member of the EAG and the computing member are members of the EAG; and

(ii) Taken into account in a taxable year that begins after the effective date of section 199A(g) and ends with or within the taxable year of the computing member with respect to which the section 199A(g) deduction is computed.

(2) Example. The following example illustrates the application of this paragraph (h).

(i) Example. (A) Specified Cooperatives X, Y, and Z are members of the same EAG. Neither X, Y, nor Z is a member of a consolidated group. X and Y are calendar year taxpayers and Z is a June 30 fiscal year taxpayer. Z came into existence on July 1, 2017. All of X, Y's, and Z's activities are patronage sourced. Each Specified Cooperative has taxable income that exceeds its QPAI and W-2 wages in excess of the section 199A(g)(1)(B) wage limitation. For the taxable year ending December 31, 2018, X's QPAI is $8,000 and Y's QPAI is ($6,000). For its taxable year ending June 30, 2019, Z's QPAI is $2,000.

(B) In computing X's and Y's respective section 199A(g) deductions for their taxable years ending December 31, 2018, X's taxable income or loss, QPAI and W-2 wages and Y's taxable income or loss, QPAI, and W-2 wages from their respective taxable years ending December 31, 2018, are aggregated. The EAG's QPAI for this purpose is $2,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000)). The $180 deduction is allocated to each of X and Y in proportion to their respective QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199A(g) deduction. Pursuant to paragraph (c)(1) of this section, in allocating the section 199A(g) deduction between X and Y, because Y's QPAI is negative, Y's QPAI is treated as being $0. Accordingly, X's section 199A(g) deduction for its taxable year ending December 31, 2018, is $180 ($180 × $8,000/($8,000 + $0)). Y's section 199A(g) deduction for its taxable year ending December 31, 2018, is $0 ($180 × $0/($8,000 + $0)).

(C) In computing Z's section 199A(g) deduction for its taxable year ending June 30, 2019, X's and Y's items from their respective taxable years ending December 31, 2018, are taken into account. Therefore, X's taxable income or loss and Y's taxable income or loss, determined without regard to the section 199A(g) deduction, QPAI, and W-2 wages from their taxable years ending December 31, 2018, are aggregated with Z's taxable income or loss, QPAI, and W-2 wages from its taxable year ending June 30, 2019. The EAG's QPAI is $4,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000) + Z's QPAI of $2,000). The EAG's section 199A(g) deduction is $360 (9% × $4,000). A portion of the $360 deduction is allocated to Z in proportion to its QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199A(g) deduction. Pursuant to paragraph (c)(1) of this section, in allocating a portion of the $360 deduction to Z, Y's QPAI is treated as being $0 because Y's QPAI is negative. Z's section 199A(g) deduction for its taxable year ending June 30, 2019, is $72 ($360 × ($2,000/($8,000 + $0 + $2,000))).

(i) Partnership owned by expanded affiliated group--(1) In general. For purposes of section 199A(g)(3)(D) relating to DPGR, if all of the interests in the capital and profits of a partnership are owned by members of a single EAG at all times during the taxable year of such partnership (EAG partnership), then the EAG partnership and all members of that EAG are treated as a single taxpayer during such period.

(2) Attribution of activities--(i) In general. If a Specified Cooperative which is a member of an EAG (disposing member) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by an EAG partnership, all the partners of which are members of the same EAG to which the disposing member belongs at the time that the disposing member disposes of such property, then the disposing member is treated as conducting the MPGE activities previously conducted by the EAG partnership with respect to that property. The previous sentence applies only for those taxable years in which the disposing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the disposing member is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or

loss is taken into account. Likewise, if an EAG partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by a member (or members) of the same EAG (the producing member) to which all the partners of the EAG partnership belong at the time that the EAG partnership disposes of such property, then the EAG partnership is treated as conducting the MPGE activities previously conducted by the producing member with respect to that property. The previous sentence applies only for those taxable years in which the producing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the EAG partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the EAG partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(ii) Attribution between expanded affiliated group partnerships. If an EAG partnership (disposing partnership) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by another EAG partnership (producing partnership), then the disposing partnership is treated as conducting the MPGE activities previously conducted by the producing partnership with respect to that property, provided that each of these partnerships (the producing partnership and the disposing partnership) is owned for its entire taxable year in which the disposing partnership disposes of such property by members of the same EAG.

With respect to a lease, rental, or license, the disposing partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(iii) Exception. No member of an EAG other than an exempt Specified Cooperative is attributed nonpatronage activities conducted by an EAG partnership. An EAG partnership is not attributed nonpatronage activities conducted by any member of the EAG or by another EAG partnership.

(j) Applicability date. The provisions of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. Taxpayers, however, may rely on these regulations until that date, but only if the taxpayers apply the rules in their entirety and in a consistent manner.

Par. 3. Section 1.1388-1 is amended by adding paragraphs (f) and (g).

The additions read as follows:

§1.1388-1 Definitions and special rules.

* * * * *

(f) Patronage and nonpatronage. Whether an item of income or deduction is patronage or nonpatronage sourced is determined by applying the directly related use test. The directly related use test provides that if the income or deduction is produced by a transaction that actually facilitates the accomplishment of the cooperative's marketing, purchasing, or services activities, the income or deduction is from patronage sources. However, if the transaction producing the income or deduction does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income or deduction is from nonpatronage sources. Patronage and nonpatronage income or deductions cannot be netted unless otherwise permitted by the Internal Revenue Code or regulations issued under the relevant section of the Internal Revenue Code, or guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(g) Effective/applicability date. The provisions of paragraph (f) of this section apply to taxable years ending after the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*. However, taxpayers may rely on the provisions of paragraph (f) of this section until the date the Treasury decision adopting these regulations as final regulations is published in the *Federal Register*.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

<FRDOC> [FR Doc. 2019–11501 Filed 6–18–19; 8:45 am]

<BILCOD> BILLING CODE 4830–01–P

[FR Doc. 2019-11501 Filed: 6/18/2019 8:45 am; Publication Date: 6/19/2019]